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STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

IN THE MATTER OF THE PETITION OF L.M.H. UTILITIES CORP. FOR AUTHORITY TO INCREASE RATES AND FOR APPROVAL OF A FINANCING PLAN	))))	**CAUSE NO. 43022** **APPROVED:** MAR 2 2 2007

BY THE COMMISSION
Gregory D. Server, Commissioner
Lorraine Hitz-Bradley, Administrative Law Judge

On April 20, 2006, L.M.H. Utilities Corp. ("Petitioner" or "LMH") filed its *Petition to Increase Rates and for Approval of Financing Plan* initiating this Cause. Pursuant to notice as provided for by law, an evidentiary hearing was convened in Room E306 of the Indiana Government Center South, Indianapolis, Indiana on December 8, 2006. LMH and the OUCC offered evidence, all of which was received into the record without objection, as well as a *Stipulation and Settlement.*

We find that approval of the proposed settlement is not in the public interest. As background to our decision, we set forth relevant parts of LMH's regulatory history, including the evidence and issues in this cause.

1. **Regulatory and Procedural History.** The Commission granted LMH its certificate of territorial authority ("CTA") on August 22, 1990 in Cause No. 38965. At that time, LMH had already been serving customers for three (3) years. As part of the Order granting LMH its CTA, the Commission ordered LMH to file for approval of its rates and charges. *See*, Public's Ex. 1, p. 7, lines 6-11.

As part of its initial rate case in Cause No. 39104, LMH requested a tap-on fee of $800.00 for first-time customers; approval of a bank loan of $150,000; the cost option for sewerage main extensions as set out in 170 I.A.C. 8-5-4-32(a)(1); approval of an affiliated interest contract; sewer main extension, customer contract, and employment agreements; depreciation expense; and proposed rules and regulations. The OUCC and LMH settled the case, and stipulated to a rate of return of 5.02%, although the Commission noted that LMH's books and records showed negative equity of ($33,771.) *In the Matter of the Petition of L.M.H. Utils. Corp.,* Cause No. 39104, 1993 Ind. PUC LEXIS 8, at *6 (Ind. Util. Regulatory Comm'n Jan. 20, 1993.) LMH and the OUCC also stipulated to rate base in the amount of $278,898. *Id.* at *10-11. The Commission accepted the settlement premised on LMH's assertions that the amount was calculated to cover its annual debt service, *pro forma* operation and maintenance expenses. Further, the Commission noted that "[t]he parties subsequently stipulated to a tap-on fee of $625 and that no further connection charge would be made to connect customers to Petitioner's system," which replaced LMH's previous request for both tap-on and connection fees. *Id.* at *9. The tap-on charge was supported by "evidence of actual expenses associated with" connections made to LMH's system; the Commission emphasized that LMH was thereby authorized to impose only the tap-on charge of $625.00. *Id.* Jerry Tucker, (then-President and now-Director of LMH) submitted an *Affidavit* stating that he was unaware of the need

to seek prior Commission approval before obtaining financing. The Commission thus approved LMH's long-term debt retroactively, excusing LMH's failure to obtain prior approval for the financing on the grounds of "exigent circumstances." *Id.* at *11.

As to the request for approval of affiliate interest contracts, the Commission found that LMH and Tucker Development Corporation were affiliated interests under I.C. §8-1-2-49, as the president of LMH was also the president and majority shareholder of Tucker Development. *Id.* at *12. The order noted that LMH had filed an affiliated interest contract with the Commission, "which, upon approval by the Commission, will be executed by [LMH] and Tucker Development." *Id.* at *13. The Commission noted that I.C. §8-1-2-49 states that no affiliate contracts are effective unless first filed with the Commission; the Commission therefore is empowered to disapprove any such contract if it is found not to be in the public interest. After reviewing the contracts, the Commission found them to "have been filed in compliance with the statute," on the grounds that "services and materials are to be provided to [LMH] at cost and that no profit is to be made by either affiliated interest from transactions with [LMH.]" *Id.* at *14. However, because there were no specific costs included in the contracts, the Commission stated that it could "only find that both contracts should not be disapproved." *Id.*

On July 15, 1994, LMH filed a request for a CTA expansion and financing approval, which was docketed as Cause No. 40004. During that case, issues were identified with LMH's books and records, and LMH was also cited by the Indiana Department of Environmental Management ("IDEM") for failure to comply with environmental regulations. As part of the settlement ultimately reached between the OUCC and LMH, LMH agreed to maintain its books and records pursuant to National Association of Regulatory Utility Commissioners ("NARUC") standards, to remain in compliance with its IDEM Agreed Order dated August 1994, and to solicit bids from contractors for all future construction projects with an estimated cost greater than $10,000. The Commission approved the *Stipulation and Settlement* by order on May 3, 1995. *Petition of L.M.H. Utils. Corp.*, Cause No. 40004, 1995 Ind. PUC LEXIS 207 (Ind. Util. Regulatory Comm'n May 3, 1995.)

On July 19, 1997, LMH filed another petition for new rates and an expansion of its CTA. The Commission's *Order on Less than All the Issues* noted that LMH had agreed, through a stipulation and settlement with the OUCC, to provide certain statutorily-required items,[1] and that the expansion would not be granted until those items were filed. *Amended Petition of LMH Utilities for Approval of New Rates and Expanded Territory*, Cause No. 40891, *Order on Less than All the Issues*, 1998 Ind. PUC LEXIS 99 (Ind. Util. Regulatory Comm'n Jan. 21, 1998.) The Commission stated that "[n]o fair value evidence was offered by either party in this case," and that the previous rate case found the fair value rate base to be $278,898.[2] *Id.* at *7. Based on a representation that LMH proposed to "set its rates and charges to produce revenue sufficient to cover its pro forma operation and maintenance expense," the Commission approved the rate increase as agreed to between the OUCC and LMH. *Id.* at *7. Subsequently, LMH filed the required documentation, and the OUCC filed no objection in response. The Commission then granted the CTA expansion, which included two properties added in response to an emergency request by LMH. *Amended Petition of*

[1] Pursuant to 170 I.A.C. 8.5-3-1, LMH was to provide a letter of approval from IDEM; a letter from DNR regarding the proposed facility's impact on wetlands, endangered species, or archeological sites; plans and specifications of sanitary sewers, and a statement of estimated costs of construction of the collection system.

[2] That amount was pursuant to stipulation in the settlement in Cause No. 39104.

L.M.H. Utils. Corp. for Approval of New Rates and Expanded Territory, Cause No. 40891, 1998 Ind. PUC LEXIS 249 (Ind. Util. Regulatory Comm'n Aug. 5, 1998).

On March 31, 1999, LMH filed another petition seeking to expand its CTA. At the time of the Commission's March 22, 2000 *Order*, LMH had not yet filed the required letter from IDEM, approval from DNR, or plans and specifications of its sanitary sewers, all of which it had agreed to provide in its settlement with the OUCC. *Amended Petition of LMH Utilities Corp., for Approval of an Expanded Territory*, Cause No. 41413, 2000 Ind. PUC LEXIS 102 (Ind. Util. Regulatory Comm'n Mar. 22, 2000). The Commission noted that the OUCC and members of the public at the public field hearing complained about LMH's "terrible odor problem," which LMH had previously agreed to resolve. *Id.* at *6. The OUCC's prefiled testimony recommended that the CTA expansion be denied until an independent third party could examine and resolve the problem. *Id.*

By the time of the January 18, 2001 evidentiary hearing, LMH and the OUCC had reached a stipulation and settlement that resolved "all of the issues between the two parties." *Id.* at *7. As part of that settlement, LMH agreed to implement remediation suggestions made by an independent third-party engineering firm. *Id.* Limitations were also placed on the ability of LMH to connect new customers, and LMH agreed to meet with the OUCC if either the OUCC or the Commission received further complaints regarding odors. *Id.* at *8. The Commission withheld approval of the requested expansion until LMH resolved its odor problem. *Id.* at *9. After LMH submitted the required documentation and complied with the further requirements of the *Interim Order* regarding its odor problem, the Commission granted the territorial expansion. *Amended Petition of LMH Utilities Corp., for Approval of an Expanded Territory*, Cause No. 41413, 2001 Ind. PUC LEXIS 169, at *7-8 (Ind. Util. Regulatory Comm'n May 24, 2001).

LMH filed its *Petition* in this matter on April 20, 2006, seeking "approval of a financing plan which will allow it to expand its plant and capacity... [and] new rate[s] and charges in order to finance its improvements." Petitioner's Exhibit 1. On May 31, 2006, the Commission issued a prehearing conference order which memorialized the agreement of the parties regarding scheduling and the dates for the test year, accounting and engineering evidence ("Test Year and Evidence Cut-off Date"), all of which were set at December 31, 2005. LMH requested, and was granted, a seven day extension of time to file its case in chief. Pursuant to that schedule, on July 21, 2006, LMH prefiled its case-in-chief, consisting of the direct testimony and exhibits of Jay Tucker, President of LMH, Christopher Limcaco, P.E., and Theodore J. Sommer. LMH filed its work papers on July 25, 2006.

On August 2, 2006, LMH filed its *Petition for Immediate and Interim Approval of Financing Plan*, in which LMH asserted that LMH was in need of "immediate and interim approval of its financing plan," as it was in the process of expanding its sewer plant and required funds to pay its contractors. The petition was not verified and contained no exhibits or other evidence in support of the requested expedited relief. On August 11, 2006, LMH filed its *Motion to Modify Test Year and Evidence Cut-off Adopted in Prehearing Conference Order.* In its Motion, LMH stated that the "mutually agreed upon procedural schedule and other dates" that had been adopted as part of the Commission's May 31, 2006, prehearing conference order needed to be changed. In support of that request, LMH stated:

> Consistent with its prefiled testimony and supporting work papers filed in this Cause, LMH seeks to clarify for the Commission and the OUCC that it intends to include both the proposed $750,000.00 debt service and the additional plant improvements to be financed by the debt service within its proposed new rate base.
>
> In order to include the additional plant improvements, which did not occur until after 2005 and have yet to be completed, within LMH's new rate base, the 2005 Test Year and 2005 Evidence Cut-Off Date will need to be extended to include the twelve month period following the end of the 2005 Test Year and the 2005 Evidence Cut-Off Date, respectively.

Motion, p.2.

The *Motion* further stated that Commission precedent in *In the Matter of the Petition of Green Acres Sanitation*, Cause No. 42891, *Phase II Order* (Feb. 6, 2006), supported the request for such a change.

On August 15, 2006, the OUCC filed its *Objection to Petitioner's Motion to Modify Prehearing Conference Order,* arguing that the request violated Commission practice; was not supported by Commission precedent, as Cause No. 42891 was a settled case and therefore of no precedential value; and that use of a future rate base violated the statutory requirement that plant be "used and useful" prior to inclusion in rate base. LMH filed its *Reply* to the OUCC's objection on August 22, 2006.

On September 19, 2006, the Presiding Officers issued a docket entry denying LMH's requests for interim financing relief and test year modification. The Presiding Officers noted that Cause No. 42891, *Green Acres,* was both distinguishable from the case at bar and not a settlement, which resolved the issue of its precedential value.[3] In addition, the Presiding Officers noted that the change of the test year had not been 'anticipated,' as argued by LMH, and that the inclusion of the "as-yet-incomplete utility plant" violated both the "used and useful" and "fixed, known, and measurable" rules of rate relief. Finally, the Presiding Officers denied the requested interim relief as follows:

> The request was not verified, did not include any attachments as support for the interim relief, and did not identify the contractors in question or the amount due to them. LMH did not cite any unexpected occurrences necessitating the extraordinary relief requested, and did not make reference to any emergency in support of the requested relief. Finally, LMH did not offer any explanation as to why it could not foresee such a circumstance arising. In the absence of evidence supporting LMH's request, we are disinclined to grant such extraordinary relief.

September 19, 2006 docket entry, at p. 5.

[3] Due to a clerical error, the settlement from a different case (Cause No. 41584) was erroneously attached to the Phase 2 Order in Green Acres, Cause No. 42891. The Commission issued *nunc pro tunc* orders in both causes on August 30, 2006 to resolve these discrepancies in the record.

The Presiding Officers also issued a separate docket entry on September 19, 2006 setting a public field hearing date for October 16, 2006, and continued the evidentiary hearing *sua sponte* until November 2, 2006. Subsequently, the parties requested and received another modification to the procedural schedule, and the evidentiary hearing was continued to December 8, 2006 via docket entry issued on September 22, 2006.

On October 16, 2006, a properly-noticed field hearing was conducted in the cafeteria of the Sunman-Dearborn Intermediate School, West Harrison, Indiana. At the field hearing, LMH and the OUCC appeared and various members of the rate-paying public provided both written and oral testimony. LMH offered an exhibit marked as Petitioner's Field Hearing Ex. 1, titled "Frequently Asked Questions Regarding the LMH Rate Increase and New System Development Charge." The OUCC offered into evidence its Field Hearing Ex. 1, consisting of written comments by LMH customers in attendance at the field hearing. Customers opposed the rate increase, and a number questioned how the company determined the bills, stating that their bills had doubled in the time between 1998 (LMH's last rate case) and the present. *See*, OUCC Ex. FH-1, comments of Merlinda M. Barry, Gwen and Gary Hessler. Other customers questioned how LMH had planned for system expansion. *Id.*, comments of Jeff Martin and David Kirchgessner. Numerous customers objected to the rate increase and complained that they were already paying higher rates than customers of other local sewage companies. *Id.*, comments of Kathy Bollinger, Gwen and Gary Hessler, and Jane Fliehman. In addition, customers objected to the rate increase being used to build a system expansion that would not benefit current customers; several objected to paying higher rates while "the investors just pocket the profits." *Id.*, comments of Richard Norfleet and Michael Burgess. One customer also questioned the relationship between LMH and the Tucker companies. *Id.*, comments of Kenneth Wade.

The OUCC filed its responsive testimony on November 6, 2006 and its workpapers on November 8, 2006. The OUCC's responsive testimony was submitted by Judith I. Gemmecke, Harold R. Rees, and Edward R. Kaufman. Attached to Ms. Gemmecke's testimony were additional comments received by the OUCC from LMH customers either at or after the field hearing. *See*, Public's Ex. 1, Attachment JIG 4. One customer complained of LMH's previous environmental violations and odors, and expressed concern regarding expansion in light of those problems. *Id.*, p. 1, comments of Linda Johnson. Another objected to LMH's un-audited records being used as a basis for a rate increase. *Id.*, p. 6, comments of Rick Cochran. Several were concerned regarding the issue of "separate but connected entities of Tucker Homes/LMH" and the possibility of financial cross-subsidies. *Id.*, p. 6-7, comments of Rick Cochran; p. 8, comments of Gerald Nixon; p. 12, comments of LaDonna Farmer; p.13, comments of Darla Cleary. Consumers also objected to paying for an investment in LMH's infrastructure, based on LMH's status as an investor-owned utility. *Id.*, p. 7, comments of Rick Cochran; p. 8, comments of Gerald Nixon.

On December 1, 2006, the OUCC and the LMH filed a *Joint Stipulation and Settlement Agreement* (the "Settlement Agreement") along with supporting testimony sponsored by LMH's witness, Theodore J. Sommer and the OUCC's witness, Judith I. Gemmecke.

Pursuant to notice duly published as required by law, an evidentiary hearing was conducted on December 8, 2006 at 9:30 a.m. in Room E-306 of the ICGS. Proofs of publication of notice of the hearing were incorporated into the record and placed in the official files of the Commission. LMH and the OUCC appeared and participated at the hearing. No members of the general public appeared or otherwise sought to testify at the hearing. At the hearing, LMH and the OUCC offered

their respective prefiled testimony into the record along with the Settlement Agreement and supporting testimony. The following exhibits were entered into evidence by Petitioner LMH: Petitioner's Exhibit 1, Petitioner's Petition; Petitioner's Exhibit 2, Prefiled Evidence of Jay Tucker, President of LMH Utilities Corp.; Petitioner's Exhibit 3, Prefiled Evidence of Christopher A. Limcaco, P.E.; Petitioner's Exhibit 4, Prefiled Evidence of Theodore J. Sommer; Petitioner's Exhibit 5, Prefiled Testimony of Theodore J. Sommer in Support of Joint Stipulation and Settlement; and Petitioner's Exhibit 6, Submission of Joint Stipulation and Settlement Agreement. The following exhibits were entered into evidence by the OUCC: Public's Exhibit 1, Testimony of Witness Judy Gemmecke; Public's Exhibit 2, Testimony of Witness Harold L. Rees; Public's Exhibit 3, Testimony of Witness Edward R. Kaufman; Public's Exhibit 4, Testimony of Witness Judy Gemmecke.[4] All evidence was accepted into the record of this Cause without objection. LMH and the OUCC waived cross-examination of each other's witnesses, but tendered their witnesses for questioning by the Presiding Officers.

During the course of the hearing, LMH offered to submit a late-filed exhibit, to which the OUCC had no objection; it was agreed that the late-filed exhibit would be designated as Petitioner's Exhibit 7. This exhibit was described as Mr. Sommer's "written calculation supporting LMH's assessment of a system development charge." The exhibit was filed on December 11, 2006, and no party submitted any objection to its submission into the record. We therefore find that Petitioner's Exhibit 7 is admitted into the record of this cause without objection.

2. **Commission Jurisdiction and Notice**. Proper notices of the hearings in this Cause were given as required by law. LMH is a "public utility" within the meaning of the Public Service Commission Act, I.C. §8-1-2-1 et seq., and is therefore subject to the Commission's jurisdiction. LMH seeks approval pursuant to I.C. §8-1-2-89 to increase its base rates as well as approval for long-term financing, pursuant to I.C. §8-1-2-78. The Commission, therefore, has jurisdiction over the parties and the subject matter of this Cause.

3. **Petitioner's Characteristics**. LMH is a for-profit corporation engaged in the business of providing sewage disposal service in rural Dearborn County, Indiana, headquartered in Bright, Indiana. LMH currently serves 1,075 customers and adds approximately 67 customers per year. The utility's Picnic Woods wastewater treatment plant ("WWTP") is a 300,000 gallons per day ("GPD") sequencing batch reactor system. LMH's collection system consists of approximately 23 miles of collection and force mains, composed of PVC pipe in sizes varying from two inches to eight inches in diameter.

4. **Relief Requested**. LMH's original petition sought authority to increase its rates approximately 54.68% across the board to produce a residential and commercial rate of $59.63 (per 5,000 gallons). LMH also sought approval of a certain loan transaction with Main Source Bank to provide funding for construction of its sewer plant in an amount not to exceed $750,000. LMH sought expedited approval of its proposed long-term financing plan, but as a part of the settlement agreed to postpone that request. LMH also requested a bad check fee ("NSF") charge of $25.00 and to institute a system development charge ("SDC") of $3,000 per equivalent dwelling unit ("EDU").

As a consequence of the stipulation and settlement, the OUCC and LMH have asked the Commission to approve certain terms. In part, the parties agreed to a rate increase of 15%, subject

[4] This second offering of testimony by Ms. Gemmecke was offered "to discuss" the proffered settlement.

to refund, pending Phase II of this proceeding. The parties agreed that the $750,000 financing request is to be pursued in Phase II, and that "the proposed $750,000.00 debt service and the capital improvements financed by such debt service" will be included in LMH's permanent rate base. Petitioner's Ex. 6, (1)(b)(i). The parties further agreed that the SDC amount should be reduced to $2,500; in addition, they agreed that the SDC should be considered approved on a retroactive basis and that it is not subject to refund.

5. Evidence Offered by the Petitioner.

A. Direct Testimony of Jay Tucker. LMH offered the evidence of Jay Tucker, an Owner and the President of LMH Utilities, Corp. He has been in the position for over twenty years, and is a Class II Certified Operator of the Plant.

Mr. Tucker stated that the current plant, with 300,000 GPD capacity, needs to be expanded in light of the growth of the surrounding community, a bedroom community to Cincinnati, Ohio, and northern Kentucky. He stated that a planned subdivision and the presence of septic fields on existing properties supported this need. He stated that LMH plans to expand by adding 180,000 GPD capacity and refurbishing the current equipment, at a cost of $950,000, of which $750,000 will be borrowed.

Mr. Tucker stated that he had attached LMH's IDEM NPDES and construction permits to his testimony, and had provided all LMH's accounting information to their accountants. He stated that he also owned Utility Construction Corp., an affiliate of LMH, which provides construction and sewer main extension services to LMH. He is also an owner of the affiliated businesses Tucker Development and Tucker Homes, which are respectively real estate development and home building businesses. He concluded his testimony by stating that he had attached all the affiliate contracts to his testimony.

B. Direct Testimony of Christopher A. Limcaco, P.E. LMH offered the testimony of Christopher A. Limcaco, P.E., who stated that he had done engineering work for LMH for several years and was familiar with the utility. He referred to his résumé attached to his testimony for his qualifications and experience.

Mr. Limcaco stated that LMH needed to expand its utility plant. He stated that as he understands it, LMH is in a very fast-growing area, and needs to add two new tanks and refurbish its old equipment. He completed his testimony by stating that he designed all of the LMH improvements, and that all of the work was appropriate and necessary for the utility.

C. Direct Testimony of Theodore J. Sommer. LMH offered the testimony of Theodore J. Sommer, Certified Public accountant, partner at London Witte Group, LLC. Mr. Sommer summarized his experience and education.

Mr. Sommer stated that the purpose of his testimony was to show that LMH's rates are insufficient and that an increase in rates is necessary for LMH to provide safe and adequate service to its customers. He stated that the basis of his analysis was the test period for the twelve months ending December 31, 2005. He further testified that LMH plans to refurbish and expand its plant in response to projected growth for its service area. Mr. Sommer stated that in order to raise the capital to fund the plant refurbishment, LMH has entered into a loan commitment to borrow money.

He also stated that LMH planned to put a more systematic maintenance program in place in response to IDEM requirements.

Mr. Sommer stated that he recommended that LMH increase its monthly fee service from $42.28 to $65.40, representing a 54.682% increase. In addition, Mr. Sommer recommended a System Development Charge ("SDC") of $3,000 for each equivalent 5/8" – ¾" water meter installation, as well as a $25.00 bad check charge.

Mr. Sommer sponsored exhibits showing comparative balance sheets for LMH for the years 2004 and 2005; comparative statements of net income for 2004 and 2005; pro forma operating statements for the twelve months ending December 31, 2005; detailed adjustments to pro forma present and proposed rates, original cost rate base, pro forma capital structure, and current and proposed long-term debt; debt coverage analysis at the pro forma present and proposed rate levels; gross revenue conversion factor; and a schedule of present and proposed rates.

Mr. Sommer stated that he established the cost of capital at 11% to reflect the risk associated with "the skewed capital structure of Petitioner as well as the lack of marketability of its stock." Petitioner's Ex. 4, p. 5, lines 5-7. Mr. Sommer stated that he knew of no other proxy group to use to measure LMH's risks, so he used his best estimate based on his years of experience. He stated that he had included the proposed financing for the project, in the form of a 20-year note at a fixed rate of 8.5%, which he stated was a reasonable rate and term for this debt and customer. Mr. Sommer stated that the terms of the loan commitment that LMH had entered into with Merchants Bank were reasonable. See, Petitioner's Ex. 4, Sched. E.

Petitioner's Cost of Capital as of December 31, 2005

Description	Amount	Percent of Total	Cost Rate	Weighted Cost
Long Term Debt – Existing	151,733	14.94%		
	22,861	2.25%	*	1.45%
	58,780	5.79%		
	233,374	22.98%		
Long Term Debt - Proposed	750,000	73.86%	8.50%	6.28%
Common Equity	32,095	3.16%	11.00%	0.35%
Total	$1,015,469	100.00%		**8.08%**

* Existing Debt	Amount	% of Total		
Merchants Bank	151,733	14.94%	7.74%	1.16%
GMAC	22,861	2.25%	0.00%	0.00%
Shareholder Debt	58,780	5.79%	5.00%	0.29%
Weighted Cost of Debt	233,374	22.98%		1.45%

In support of the proposed $3,000 SDC, Mr. Sommer stated that it is very difficult for small utilities to fund projects. Mr. Sommer stated that LMH was primarily financed with contributions in aid of construction ("CIAC"), and that he did not consider that unusual, given small utilities' general difficulties trying to operate within a traditional debt-to-equity ratio. Because the project contemplated by LMH was expensive, it would typically be financed through a loan, and if that is included in rates, rates go up. However, he stated that while an "infusion of equity from Petitioner would provide a more traditional debt to equity ratio, it would not lower the overall cost of the capital that supports the rate base...when the cost of equity infusion is included in rates, the result is an even larger increase in rates...in particular for a small sewer utility the net cost of equity capital is higher than that of debt." Petitioner's Ex. 4, p. 6, lines 17-22.

Mr. Sommer stated that since the Commission determined that it would regulate SDCs, the Commission has generally been provided with a calculation either based on the equity or the incremental method. He stated that the equity method requires that debt and CIAC be netted against utility plant in service ("UPIS"), before dividing by the number of current customers. Mr. Sommer stated that because LMH's UPIS is mostly supported by debt and CIAC, the resulting SDC would be immaterial. As to the incremental method, it requires that the estimated cost be spread over the number of equivalent units calculated to benefit from the project. Since LMH plans to finance the entire project, no SDC can be justified under either of the AWWA methods. Therefore, Mr. Sommer opined that when LMH next chooses to repair or expand plant, it will have no accumulated SDCs, and will be required to finance again, bringing it again before the Commission seeking rate relief. Consequently, Mr. Sommer recommended that the Commission authorize LMH to charge an SDC of $3,000 per EDU. He finished his testimony with the statement that LMH was agreeable to segregating the SDC funds into an account used only to fund future capital developments that will be in original cost rate base. Then, when growth occurs, or the current plant needs refurbishment, the SDC funds may then obviate the need for the next rate increase and its attendant costs. Mr. Sommer therefore proposed that the Commission approve an SDC in the amount of $3,000.

6. <u>Evidence Offered by the OUCC.</u>

A. Direct Testimony of Judith Gemmecke: The OUCC presented evidence from Judith Gemmecke, Senior Utility Analyst. She testified that she had reviewed LMH's testimony and schedules, the books and records at their Lawrenceburg, Indiana office, their annual reports as filed with the Commission, income and property tax returns, and prior orders of the Commission relating to LMH.

Ms. Gemmecke testified that LMH has made no attempt to conform to the NARUC Uniform System of Accounts ("USoA") or Generally Accepted Accounting Principles ("GAAP") since its inception. Ms. Gemmecke noted that LMH's accounting practices and records have been brought into question in previous cases, including Cause Nos. 38965 and 39104. Public's Ex. 1, pp. 8-9. She stated that LMH's books are inadequate to determine with any confidence LMH's rate base or capital structure. Therefore, Ms. Gemmecke did not include a balance sheet in her testimony. Public's Ex. 1, p. 10, lines 2-3, 14-15. Ms. Gemmecke stated that she has spoken with LMH's consultants, London-Witte Group, who informed her that it would take about three months to put LMH's books and records in proper order.

Ms. Gemmecke stated that the OUCC was recommending an interim rate increase of 3.40%, with permanent rates to be established at a later date. Ms. Gemmecke stated that the OUCC

recommended approval of the $25.00 NSF fee. However, she also stated that the OUCC only recommended a system development charge of $1,575 per EDU. Ms. Gemmecke stated that the recommendation for interim rates was based on the fact that LMH's books and records were unreliable, and could not be used to determine a supportable balance sheet, capital structure, or rate base. For example, Petitioner's Exhibit 4, Exhibit A, contains LMH's Balance Sheet for 2005, reflecting UPIS as of December 31, 2005 at $1,392,338. However, Ms. Gemmecke noted that LMH's calculation in Exhibit D for its Original Cost Rate Base states the balance for UPIS, adjusted as of December 31, 2005, at $3,112,729. Ms. Gemmecke stated that this represents a discrepancy of $1,720,391. Further, Ms. Gemmecke noted that neither of these figures match the number regarding UPIS in LMH's 2005 Annual report to the Commission.

Ms. Gemmecke recommended that LMH's "outstanding debt principal [be used] as a proxy for capital invested in rate base and use[] the utility's interest obligations on that debt as a proxy for a reasonable return on that investment. This is consistent with an investor-owned utility that is 100% debt financed. The rate of return equals LMH's actual interest rates." Public's Ex. 1, p. 12, lines 11-15. Ms. Gemmecke's attached schedules set forth an analysis of LMH's current debt and the proposed additional debt.

Description	12/31/05 Amount	6/30/06 amount	Cost	Anticipated interest exp.
Common Equity	$		0.00%	
Preferred Equity	0	0	0.00%	
Deferred Income taxes	0	0	0.00%	
Long term debt- (Merchants #74900)	$151,733	130,363	7.75%	$10,103
Long term debt – GMAC	22,861	22,861	0.00%	0
Long term debt – (Jerry Tucker)	58,780	41,739	5.00%	0
Current totals	233,374	194,963		10,103
Short Term Debt	$750,000	750,000	8.25%	$61,875
Pro forma total	$983,374	$944,963		$71.978

Public's Ex. 1, Sched. 5, p. 1.

Ms. Gemmecke stated that the OUCC's recommendation was based on the utility's outstanding debt, which she used as a proxy for a reasonable rate of return on the investment. Ms. Gemmecke stated that the OUCC was basically giving LMH the benefit of the doubt that nearly all of its long-term debt was invested in rate base. In addition, Ms. Gemmecke stated that because there was no reliable basis for establishing a capital structure with certainty, the OUCC proceeded on the assumption that LMH is 100% debt financed. As a result, a reasonable rate of return equals the interest on LMH's outstanding third-party debt.

OUCC's Proposed Revenue Requirements	
Operating and Maintenance Expenses	$560,918
Proforma Present Rate Taxes	28,625
Depreciation Expense	-
Interest Expense	71,978
Proposed Revenue Requirements	661,520
Less: Other Operating Revenue	75,640
Add: Other Expenses	300
Net Revenue Requirements	586,180
Less: Pro-forma Present Rate Revenue	571,339
Net Revenue Increase Required	14,842
Add: Additional IURC Fee	21
Additional Utility Receipts Tax	272
Additional State Income Tax	1,647
Additional Federal Income Tax	2,619
OUCC Recommended Increase	19,401
Percentage Increase/(Decrease)	3.40%

Public's Ex. 1, Sched. 1, p.1.

Ms. Gemmecke stated that a review of the previous Commission proceedings brought by LMH reveals that LMH has a history of requesting authority for CTAs, rates, and financing after it has already implemented the requested items. Ms. Gemmecke noted that in the past, the OUCC and the Commission have expressed concerns over LMH's accounting practices, which have not been in compliance with standards pursuant to the NARUC USoA or GAAP.

As examples, Ms. Gemmecke noted that LMH began operations three years before it requested a CTA from the Commission. During those three years, LMH had been collecting usage and tap-on fees from customers without Commission approval. Further, LMH did not request approval of its rates and charges; instead, the Commission ordered LMH to file a rate case. Ms. Gemmecke also cited the fact that LMH sought Commission approval after it obtained long-term financing in Cause Nos. 39104 and 40004. Further, in Cause No. 40891, LMH requested an expansion of its CTA and an increase in its rates and charges. At the time that LMH filed its request, LMH already had a shareholder loan for which it had not sought prior Commission approval. Ms. Gemmecke also stated that LMH did not request authority to include that debt in its capital structure.

Ms. Gemmecke noted that LMH began charging a System Development Fee, which LMH refers to as a Developer Fee, in 2001. According to the work papers filed in this Cause, Ms. Gemmecke testified that LMH has collected a total of $495,050 in fees through December 31, 2005. Ms. Gemmecke stated that this is the fee that LMH requests approval to charge in this case. Further, while LMH is requesting long-term financing authority, it went ahead and got short-term financing in August 2006, prior to Commission approval.

Ms. Gemmecke testified that since its inception, LMH has kept its books on a cash basis, using a depreciation method that has not been approved by the Commission. It has not accounted for CIAC, and has not properly accounted for cash advances for construction. She stated that LMH's original CTA application contained a financial statement dated 12/31/1989. That statement said that LMH and a related party incurred a start-up capital expense of $152,248, and that the expense was offset by $180,000 of tap-on fees. However, Ms. Gemmecke stated the balance sheet presented for the year ending 12/31/1989 shows treatment facilities of $163,053, a note payable to the shareholder of $150,754, and makes no mention at all of the $180,000 in tap-on fees. The LMH 1990 annual report submitted to the Commission states that the previous year's ending note payable balance was $63,751. Ms. Gemmecke stated that sometime between the reports dated December 31, 1989, submitted as part of Cause No. 38965, and the 1990 Annual Report (also dated December 31, 1989), $87,000 was paid to shareholders.

Ms. Gemmecke noted that LMH's accounting practices were first called into question in Cause No. 39104, when the OUCC's witness stated that the books and records were insufficient for purposes of establishing conventional rates. Ms. Gemmecke stated that nothing had changed to date except the numbers presented, and the more she looked at the records, the less confidence she had in the numbers. Ms. Gemmecke stated that even the balance sheet in Cause No. 40891 was of no assistance, because the accounting problems have been present since the inception of the utility. Further, Cause No. 40891 was a settled case; Ms. Gemmecke stated that reliance on those financial statements would be ill-advised. She believes that the parties in that case were trying to fit a square peg into a round hole by essentially manufacturing inputs into a traditional ratemaking formula.

Ms. Gemmecke therefore recommended that interim rates be entered that would cover expenses of the operations and interest due on the current outstanding debt. She recommended that only after LMH's books and records were in order should long-term rates be entered. She recommended against including the principle on the requested debt, because it would need to be recorded as CIAC. The OUCC has concerns that LMH has insufficient rate base to sustain the utility, and Ms. Gemmecke stated that the addition of more contributed plant would make the situation worse. Further, the OUCC is concerned that if there is little or no investor-supplied plant, the shareholders have nothing to motivate them to run an effective organization, and consumers could lose their service and have no alternatives.

Ms. Gemmecke stated that she made revisions to LMH's test year revenue reflecting residential growth. She also reclassified certain items that LMH designated as cash that should have been CIAC. She stated that LMH and the OUCC agreed on the following pro-forma present rate adjustments: Residential Sales, Salaries and Wages, Sludge Disposal, Meter Reading Expense, Insurance Expense, Rate Case Expense, IURC Fee and Payroll Taxes. Ms. Gemmecke also reclassified certain items that previously had been listed as expenses that should have been listed as assets.

Ms. Gemmecke said that the OUCC made adjustments to non-recurring expenses, a subsequent connector fee payment, and state utility receipts tax items. Ms. Gemmecke did not agree with LMH's expense adjustments for employee benefits, customer growth adjustment, extensions paid from developer fees, depreciation, and property, state and federal income taxes. In addition, Ms. Gemmecke did not agree with two expense adjustments for testing expenses and operations and maintenance service, both of which were performed by LMH's affiliates.

Ms. Gemmecke stated that the OUCC has concerns with the services provided by Utility Construction Corporation ("UCC"), LMH's affiliate. The contracts between LMH and UCC were in LMH's prefiled testimony. No prices were listed in the contract, but based on the records, at the end of the test year LMH had paid its affiliate $7,175.00 per month for operations and general maintenance, $1,600 per month for laboratory testing, and $6,200 per month for sludge processing. LMH also paid UCC "special maintenance fees" for items such as weekend plant oversight, checking for sewer line leaks, repairs to blowers, clearing debris and cleaning lift stations. The OUCC is concerned about this contract, because LMH is proposing to add an additional employee to perform the task of assistant plant manager. In Ms. Gemmecke's opinion, this would result in a reduction of responsibilities to the affiliate. However, LMH is also proposing to increase the amount that LMH is paying UCC under the contract.

Ms. Gemmecke believes that this supports adjustments to the proposed expenses for LMH's affiliate. She stated that LMH offered the proposal from a third-party for full-time operation of its facilities as support for the increase in expenses to its affiliate, even though the third-party contract contained much broader duties than what UCC provides. She noted that LMH is requesting rates to cover salaries for its own personnel, plus another $120,000 per year to its affiliate, for plant management that UCC will no longer perform. Ms. Gemmecke stated that the amount to the affiliate should be reduced from $120,000 to $16,000, which is $120,000 less the $104,000 in salaries, benefits and taxes paid to LMH employees. Likewise, no evidence was offered to support the cost of the lab fees charged by UCC to LMH, either for the current cost or the proposed increase in rates. Ms. Gemmecke summarized the respective positions of the OUCC and LMH regarding affiliates expenses as follows.

OUCC's position	**Plant O&M**	**NPDES Testing**	**Sludge Pressing**	**Total**
Pro forma Expense	$16,000	$19,200	$74,400	$109,600
Less test year expense	83,070	18,000	69,450	170,520
Adjustment - Increase (Decrease)	($67,070)	$1,200	4,950	($60,920)

LMH's position	**Plant O&M**	**NPDES Testing**	**Sludge Pressing**	**Total**
Pro forma Expense	$120,000	$20,400	$74,400	$214,800
Less test year expense	83,070	18,000	69,450	170,520
Adjustment - Increase (Decrease)	$36,930	$2,400	4,950	$44,280

Public's Ex. 1, p.19.

Ms. Gemmecke stated that the NARUC rules on affiliates recommend that the price for services, products, and the use of assets provided by a non-regulated entity (such as LMH affiliates UCC, Tucker Development, Tucker Homes, Jet Enterprises and any other companies with common ownership and control) should be at the lower of fully allocated cost or prevailing market prices. LMH and its affiliates have contracts with no fixed sum amounts, which therefore do not allow comparison to market prices or allocated costs. Therefore, she recommended that a complete review of LMH's affiliate contracts be performed as part of a full-fledged rate case. She noted that LMH's customer growth adjustment that decreased operating expenses was not adopted by the OUCC,

because LMH's consultant took the information from the 2005 annual report, which was not consistent with LMH's books and records.

Ms. Gemmecke also testified about LMH's SDC. She stated that such charges are also known as development fees, impact fees, capital recovery fees, and capacity charges. Such fees are used to finance capital projects, are usually paid by customers when they connect to the system, and are not common in investor-owned utilities. Ms. Gemmecke stated that the reason for this is that investors want to earn a return on the plant; if others pay for the infrastructure, the shareholders do not earn a return because they are not the ones who invested the funds. Nonetheless, SDCs have been approved for investor-owned utilities, and each fee must be examined on its own merits.

Ms. Gemmecke stated that in this case, LMH has an undetermined rate base, which appears to have been obtained through debt and contributions with little or no investment by shareholders. This has resulted in little or no rate base upon which shareholders can earn a return. The shareholder loan that funded the start-up of LMH has been re-paid through revenues of LMH. The pending expansion is proposed to be funded through debt, and not stock. Thus, LMH has low equity, and the shareholders have little incentive to see the company thrive; the SDC covering 100% of future capital investments exacerbates the situation.

Ms. Gemmecke explained the different ways of calculating an SDC, and stated that she used the marginal or incremental approach, which functions on the idea that new users should be responsible for the cost of the next increments of capacity that are constructed. Ms. Gemmecke calculated an SDC of not more than $1,575 per 5/8" meter. Because of concerns about LMH's accounting methods, Ms. Gemmecke recommended a detailed accounting showing who paid the SDC, the amount paid, and any conditions upon which it was made. Further, she stated that the cash from the SDC must be segregated and used only for capital projects that become necessary due to additional volumes of flow. Further, capital project purchases must be traceable to invoices; the money should be kept in a segregated fund that generates interest and should be designated as restricted for that use only.

Therefore, Ms. Gemmecke recommended that only interim rates should be approved until LMH's books are restated in conformity with NARUC's USoA and prior Commission orders. Further, a review of all affiliate contracts and pricing should be done at that time, and a SDC of not more than $1,575 should be approved, as well as a returned check charge of $25.00.

B. Direct Testimony of Hal Rees. The OUCC offered the testimony of Hal Rees, Senior Utility Analyst. He provided analysis of LMH's wastewater system.

Mr. Rees noted that LMH provides sewer service in the unincorporated area of Bright, Indiana. He stated that sewer service is inconsistent because some homes have private septic systems. He stated that many homes connected to LMH's system have sump pumps with sump lines connected to LMH's system, increasing rainwater flow into LMH's system. Mr. Rees stated that he believed that developer practices were responsible for this.

Mr. Rees noted that LMH's collection system is made up of PVC pipe varying between two and eight inches in diameter. LMH also has several lift stations with electric pumps. He stated that LMH's wastewater treatment plant has expanded to a current capacity of 300,000 GPD. He stated that new capacity will be required, but not as quickly as LMH has forecasted. LMH forecasts that

the expanded plant of 480,000 GPD will exhaust capacity by 2014; the OUCC's calculations (using LMH's own figures) show capacity exhaustion in 2016.

Mr. Rees stated that it was difficult to rate LMH's system, given the amount of improvements that are in progress. While he rated LMH at average to below-average previously, Mr. Rees stated that once the improvements are completed, LMH should be able to provide good service, as well as handle projected growth.

Mr. Rees recited the improvements to the WWTP. Mr. Rees noted that the cost for the improvements are variously shown in LMH's exhibits as $1,155,000, $950,000, and $1,142,581. Mr. Rees also explained that IDEM noted certain deficiencies based on a recent inspection of LMH's facilities. LMH was not reporting who was performing sampling, measurements, and analysis. Mr. Rees noted that Jay Tucker of LMH assured IDEM that the matters either had been or would be corrected, by letter on April 24, 2006.

Mr. Rees recommended that LMH complete the improvements and then allow the OUCC the opportunity to tour the facilities. He also recommended that LMH use high efficiency motors when the time comes to replace them, as the energy savings will offset the initial higher cost. Finally, he recommended that LMH investigate the possibility of a non-usage-based fee for customers with sump line connections. This fee would act to offset the capacity costs caused by the increased usage.

C. Direct Testimony of Edward R. Kaufman. The OUCC offered the testimony of Edward R. Kaufman, Senior Utility Analyst. He offered his testimony regarding LMH's capital structure and financial condition.

Mr. Kaufman stated that based on the figures in Mr. Sommer's testimony, if LMH proceeds with its proposed long-term borrowing of $750,000, LMH will have a capital structure with only 3.16% equity and 96.84% debt. Even before issuing the debt, LMH's investor-supplied capital structure had less than 12.50% equity and 87.5% debt. Mr. Kaufman stated that both equity rates are far too low. In his experience investor-owned utilities should have at least 35.0% common equity and no more than 65.0% debt.

Mr. Kaufman stated that the OUCC could not rely on the capital structure in Mr. Sommer's testimony because LMH's books and records are in such disarray, as discussed by Ms. Gemmecke. Mr. Kaufman also stated that based on certain adjustments made by Ms. Gemmecke, it is possible that LMH has negative equity.

Mr. Kaufman reviewed *AUS Utility Reports*, a nationally recognized publication providing financial data on publicly traded U.S. utilities. Based on the September 2006 issue, nine of eleven water utilities have an investor-supplied equity ratio of between 43.0% and 54.0%, and the average equity ratio is 48%. The lowest equity rate is 38%, and the highest is at 57%. These are considered reasonable equity ratios for water utilities.

Mr. Kaufman stated that he has concerns about LMH's equity and proposed debt, because as a company's equity ratio decreases, its financial risks increase. The more debt a company takes on, the more fixed obligations it has, which may lead to a decision to defer maintenance or needed improvements because of the need to satisfy the debt. If a firm's investor-supplied equity drops

below 35.0%, it is cause for concern; if it is below 25.0%, corrective action needs to be taken. As a consequence, Mr. Kaufman believes that LMH should not be allowed to issue its proposed debt unless it also increases its common equity and maintains reasonable ratios between debt and equity. Because of the disarray of LMH's books, the OUCC cannot determine LMH's capital structure or really comment on LMH's proposed debt issuance.

Mr. Kaufman stated that LMH has already obtained the proposed financing of $750,000 on August 4, 2006, via short term debt, and that it intends to use the proceeds as it would have used the long term debt. As of the date of the OUCC's filing of testimony, Mr. Kaufman noted that LMH had not notified either the OUCC or the Commission of the short-term debt. Mr. Kaufman stated that LMH knew of the OUCC's concerns, yet it issued short term debt, and has already expended most of the funds it obtained. Mr. Kaufman stated that LMH's low equity and the state of its financial records were sufficient reason for the Commission to deny LMH's requested relief of the long-term debt. He acknowledged that LMH's use of the short term debt placed both the Commission and OUCC in a difficult position. Mr. Kaufman stated that LMH has essentially painted itself into a corner, and is asking the Commission to bail it out; denying the debt will put LMH in a potentially more difficult position. Still, Mr. Kaufman stressed that the proposed debt should be judged on its own merits, and that the Commission should not be forced to grant authority that it would otherwise have denied.

Therefore, Mr. Kaufman recommended a denial of the long-term financing until LMH's books can be re-constructed and a proper assessment can be made, as any current capital structure for LMH is purely hypothetical. Mr. Kaufman stated that the interim rate proposal includes debt service for the short-term loan. He did not include principal payments because as an investor-owned utility, principal payments made at ratepayer expense for an investor-owned utility should be considered CIAC.

Mr. Kaufman was also critical of the shareholder loan. While the lower interest rate may be a positive for the utility, Mr. Kaufman compared the payments to a repurchase of common stock, with the interest payments analogous to dividend payments. Thus, an owner can continue to withdraw money from a distressed utility through the repayment of the shareholder loan, with the payments listed as an expense, and not a dividend payment. Mr. Kaufman stated that according to the general ledger, LMH has paid, and continues to pay, its owners $2,991.38 per month, totaling almost $36,000 in the last 12 months. The books and records do not indicate whether this is principal plus interest, or only principal. Based on LMH's own testimony, Mr. Kaufman stated that LMH is severely undercapitalized; with only $32,095 equity balance in its capital structure, it should not pay the shareholders $35,000 per year. This is underscored by LMH's statement that it lost $39,314 in 2005 (absent interest and connector income); a utility in such distress should not be paying its owners "interest" (dividends) on a shareholder loan.

Mr. Kaufman concluded his testimony by stating that LMH has not provided sufficient support that its long-term debt will be issued at a competitive rate. He recommended that if LMH's debt is not outright denied, the Commission should require LMH to obtain and show at least two other bids for its proposed loan.

7. The Settlement Agreement.

A. ***Summary of the Settlement.*** On December 1, 2006, LMH and the OUCC filed a proposed *Stipulation and Settlement* for the Commission's approval. The *Settlement Agreement* proposes a two-phase proceeding, with an interim rate increase and assessment of a permanent SDC to be addressed in the initial phase of this Cause ("Phase I"), and a permanent base rate increase and long-term financing to be addressed in a second phase ("Phase II").

LMH and the OUCC agreed to an interim increase in rates for residential and commercial customers across the board in the amount of fifteen percent (15%), which the parties state is sufficient to cover only LMH's operating expenses, interest on outstanding loans, and depreciation on its existing plant in service. The rate for non-metered monthly service under this agreement would increase from $42.28 to $48.62, to be assessed as of the January, 2007 billing/invoicing. Further, the parties agreed that the interim rate increase would be subject to refund in the event the permanent rate increase ultimately approved by the Commission as part of Phase II is less than fifteen percent (15%). LMH is to provide any such refund as a customer billing credit. The *Settlement Agreement* provides that LMH may charge its customers who submit a check with insufficient funds an additional charge of $25.00.

The *Settlement Agreement* proposes that LMH work with the OUCC to restate its accounting books and records in conformance with NARUC's USoA, and endeavor to do so on or before April 1, 2007. Upon completion of the restatement, LMH is to file a report with the Commission and the OUCC, which will identify LMH's proposed revenue requirements, operating expenses, other accounting figures, and proposed permanent rate increase.

In addition, the *Settlement Agreement* proposes that LMH be allowed to assess new applicants a SDC in an amount not to exceed $2,500 per EDU. All SDCs collected are to be deposited and maintained in a separate account used solely for funding capital improvements related to increased capacity needs of LMH's sewer system. The SDC will be assessed and paid at the time of any new applicant's request for sewer service. With respect to any application for service submitted by a developer/owner of any new commercial platted development or subdivision, the SDC will be assessed for all platted/subdivided lots on an aggregate basis and shall be paid by the developer/owner at the time such developer/owner requests LMH to execute the capacity letter, which is necessary to obtain planning commission and board of health approval of such development or subdivision. The *Settlement Agreement* permits LMH to assess SDCs upon new service applications approved on or after January 1, 2007. With respect to any SDCs previously assessed by LMH, the *Settlement Agreement* provides that such charges shall be considered approved (on a retroactive basis)[5] and shall not be subject to any refund. LMH and the OUCC further agreed to engage in a discussion with the OUCC prior to December 31, 2011 about the continued appropriateness of the $2,500 SDC.

The *Settlement Agreement* defers further consideration of LMH's request for approval of its proposed long-term financing plan until Phase II of this Cause. The parties agreed that the second phase of this cause would begin when LMH notifies the Commission that it has completed its restatement of its accounting books and records in accordance with NARUC USoA. LMH and the

[5] The settlement does not provide a date upon which the SDC is deemed to have been effective.

OUCC agreed that Phase II should proceed on an expedited basis, and will deal with LMH's request for a permanent base rate increase to be based upon LMH's restated books. The parties also agreed that LMH's permanent base rate would include the proposed $750,000 debt and the capital improvements financed by such debt.

The parties agreed that the test year to be used for determining LMH's actual and *pro forma* operating revenues, expenses, operating income, and other accounting figures supporting its proposed permanent rate increase will be the twelve month period ending December 31, 2006, adjusted for changes that are fixed, known and measurable for ratemaking purposes and that occur within twelve (12) months following the end of the test year. The cut-off date for accounting and engineering evidence to be presented supporting LMH's proposed permanent rate increase was agreed to be the original cost and fair value of LMH's property used and useful in furnishing service to the public as of December 31, 2006, adjusted to include evidence of changes that are fixed, known and measurable for ratemaking purposes and that occur prior to the prehearing conference in Phase II of this Cause.

B. Testimony by LMH in Support of the Settlement. LMH offered the testimony of Theodore J. Sommer in support of the *Settlement*. He stated that through discussion with the OUCC, LMH had reached a proposed agreement on revenue requirements and other matters, including the appropriate amount for a SDC. Mr. Sommer stated that LMH had agreed to a $2,500 SDC, even though Mr. Sommer had recommended in his original testimony that the SDC should be $3,000. Mr. Sommer stated that LMH had accepted the lower amount, even though Mr. Sommer believed that his original reasons for a higher amount were still relevant. He stated that LMH needed the SDC to provide safe and adequate service to its current and future customers. Mr. Sommer stated that the estimated cost of the plant addition and refurbishment is $1,200,000, and that LMH was requesting recovery of $750,000 of debt within the capital structure. Mr. Sommers stated that LMH would be in a severe cash flow bind if it were denied the SDC, and that LMH intended to use the SDC funds only for capital additions such as the $450,000 funding gap.

Mr. Sommer testified that the settlement was in the best interests of the public because LMH is the only sewer utility operating in the area. Therefore, "it is in the public interest to formulate an amicable resolution of the OUCC's concerns with respect to LMH's accounting books and records which at the same time provides LMH with an increase in rates (albeit interim) which is sufficient to cover its current operating costs and interest on current debt financing." Petitioner's Ex. 5, pp. 2-3. Mr. Sommer stated that the settlement allows LMH to restate its books while also protecting the "public from unreasonable rates and charges. For example, the interim rate increase provided in the Settlement Agreement is supported by LMH's accounting records." *Id.* at p. 3. Further, the interim rate increase was agreed to be subject to refund, and LMH also had the opportunity to seek a permanent rate increase and financing after restating its books. Mr. Sommer ended his testimony by stating that this served the public interest because it allowed LMH to pursue its desired rate relief "without incurring duplicative costs and expenses in having to initiate a separate, subsequent proceeding before the Commission." *Id.*

C. Testimony by the OUCC Regarding the Settlement. The OUCC offered the testimony of Judith Gemmecke as Public's Ex. 4. She stated that her testimony was offered to "discuss the settlement" between the parties. Public's Ex. 4, p.1, lines 11-12. She stated that LMH had agreed to all but one of the OUCC's adjustments as previously set forth in the OUCC's testimony. The one exception is that the parties agreed to allow depreciation on fixed assets, less

CIAC, as originally proposed in LMH's testimony. While the amount for depreciation will allow for a return of currently stated cost of plant to the shareholders, it will also allow LMH to re-invest that return into plant by performing necessary replacements for aging infrastructure. Ms. Gemmecke stated that allowing LMH to use the funds generated through depreciation in this manner is in the best interest of the public. Ms. Gemmecke summarized the original positions of the parties regarding the rates in this cause.

Percentage Increase	LMH	OUCC	Settlement
	54.68%	3.40%	15.00%
Rates per 5,000 gallon	$59.63	$39.86	$44.33

Public's Ex. 4, p.3.

Ms. Gemmecke noted that once the depreciation expense was calculated, the amount of the IURC fee, utility receipts tax, and state and federal income taxes had to be recalculated. Ms. Gemmecke stated that she believed that LMH would be filing for permanent rates in April 2007, and that she will be working with LMH to construct a reliable, materially correct balance sheet from the information available.

At the hearing during which settlement testimony was presented, the Presiding Officers questioned Ms. Gemmecke regarding her testimony in Public's Ex. 4. Ms. Gemmecke had made adjustments to LMH's depreciation expense, but also stated that "[d]epreciation expense could not be calculated due to severe inaccuracies in Petitioner's records." Public's Ex. 4, Sched. 3, p.1. Ms. Gemmecke stated that she had "used Petitioner's depreciable assets net of contributions in the Settlement mainly because during negotiations, Mr. Sommer was fairly certain it would be around $3 million that could be depreciated, and that's one of the reasons why we said subject to true-up in our Settlement Agreement, so that if it comes out way lower than this, then we can make an adjustment for that." Tr. at A-36-37.

8. Petitioner's Submission of Late-Filed Exhibit. During the evidentiary hearing in this matter, the Presiding Officers requested clarification regarding certain calculations made by the parties. During questioning regarding the SDC, Mr. Sommer offered to submit an explanatory late-filed exhibit. The OUCC had no objection, and the designated exhibit (Petitioner's Exhibit 7) was filed with the Commission on December 11, 2006. As we noted above, no objection has been filed as to its entry into the record, and we have found that it is properly admitted and made part of the record of this Cause.

The document's cover page describes it as Mr. Sommer's "written calculation supporting LMH's assessment of a system development charge. Exhibit 7 supplements the prefiled testimony of Ted Sommer entered into the record of this Cause as Exhibits 4 and 5." Attached to the cover page was a letter from Mr. Sommer addressed to counsel for LMH. The body of the letter, in its entirety, states as follows:

> The customer additions shown on the schedule were provided to me by the office manager of LMH. I asked her for all customer additions commencing the year following the last general rate order of Petitioner.

> As you can see, the sum of system development charges that would have been collected at $3,000 would have gone a long way towards eliminating the need for borrowing in this proceeding.

Petitioner's Ex. 7, p.3.

The attached page contained a chart showing the number of customers added for the years 1999 to 2005, for a total of 427. The calculation stated that the "[a]mount that would have been collected since last rate case with a SDC of $3,000" was a total of $1,281,000.

9. Commission Findings. LMH's original petition in this matter requested a substantial increase in its rates as well as approval for long-term financing. The OUCC's case-in-chief identified numerous issues of concern with LMH's request, including but not limited to the continuing unreliability of LMH's books, which are not kept pursuant to applicable standards; the consequent inability of the OUCC staff to create a balance sheet or depreciation schedule from LMH's records; the substantial differences in LMH's records for the same accounting items; LMH's skewed debt-to-equity ratio; and unexamined affiliate contracts. As a consequence of these and other concerns, the OUCC in its case-in-chief recommended a 3.4% rate increase for LMH, sufficient only to cover the interest on LMH's third-party debt.[6] The OUCC recommended that long-term rates be set only after a total restatement of LMH's books.

Subsequently, pursuant to the terms of the Settlement Agreement, the parties agreed that LMH would be granted an interim rate increase of 15%, subject to refund, while it undertook efforts to address the agreed deficiencies in books and other issues identified by the OUCC in this proceeding. Following these corrective actions by LMH, the case would then proceed to a "second phase" in which the test year established in this Cause would be reset to December 31, 2006, allowing LMH to again present a rate case to the Commission.[7]

However, we note that the use of a separate test year for the second phase of this proceeding would lead to the introduction of new facts, and would in reality represent a new rate proceeding. To do so would be in contravention of the statutory prohibitions set forth in I.C. §8-1-2-42(a), which states, in relevant part, the following:

> No change shall be made in any schedule, including schedules of joint rates, except upon thirty (30) days notice to the commission, and approval by the commission...A public, municipally owned, or cooperatively owned utility may not file a request for a general increase in its basic rates and charges within fifteen (15) months after the filing date of its most recent request for a general increase in its basic rates and charges, except that the commission may order a more timely increase if:
>
> (1) The requested increase relates to a different type of utility service;
>
> (2) The commission finds that the utility's financial integrity or service reliability is threatened; or
>
> (3) The increase is based on:
>
> (A) A rate structure previously approved by the commission; or

[6] As set forth more fully below, this amount is to cover interest only on the $750,000 short-term debt obtained by LMH in August 2006, which was obtained without Commission approval.

[7] We discuss the issue of the test year in further detail below.

(B) Orders of federal courts or federal regulatory agencies having jurisdiction over the utility.

The phrase "general increase in rates and charges" does not include changes in rates related solely to the cost of fuel or to the cost of purchased gas or purchased electricity or adjustments in accordance with tracking provisions approved by the commission.

We do not find any evidence of record that the exceptions noted in I.C. §8-1-2-42(a) are present in this case. Therefore, Commission approval of the Settlement Agreement would be contrary to law, as it would approve the pursuit of an additional rate case in a period of time shorter than that allowed by statute.

However, apart from the violation of I.C. §8-1-2-42(a), we also have ample evidence in the record to fully consider the relief requested by LMH in this matter, and we will address each of the issues in turn. We begin with the general statement that settlements presented to the Commission are not ordinary contracts between private parties. *United States Gypsum, Inc. v. Indiana Gas Co.,* 735 N.E.2d 790, 803 (Ind. 2000). When the Commission approves a settlement, that settlement "loses its status as a strictly private contract and takes on a public interest gloss." *Id.,* quoting *Citizens Action Coalition v. PSI Energy,* 664 N.E.2d 401, 406 (Ind. Ct. App. 1996). Thus, the Commission "may not accept a settlement merely because the private parties are satisfied; rather [the Commission] must consider whether the public interest will be served by accepting the settlement." *Citizens Action Coalition,* 664 N.E.2d at 406. Examinations of the public interest may include the impact of a given decision on customers of various classes, the interests of the utility and its stakeholders, and the impact on the State. The interest of the State may be "more comprehensive and take a longer range view than any of the parties' interests." *Nextel West Corp. v. Ind. Util. Regulatory Comm'n,* 831 N.E.2d 134, 156-57 (Ind. App. 2005.)

The Commission is not required to accept a settlement simply because the OUCC has agreed to it, and agreements filed by some or all of the parties must still be supported by probative evidence. *Id.* Furthermore, any Commission decision, ruling, or order – including the approval of a settlement – must be supported by specific findings of fact and sufficient evidence. *United States Gypsum,* 735 N.E.2d at 795, *citing Citizens Action Coalition v. Public Service Co.,* 582 N.E.2d 330, 331 (Ind. 1991). The Commission's own procedural rules require that settlements be supported by probative evidence. 170 I.A.C. 1-1.1-17(d). Therefore, before the Commission can approve any Settlement Agreement, we must determine whether the evidence in this Cause sufficiently supports the conclusions that the settlement is reasonable, just, and consistent with the purpose of I.C. §8-1-2, and that such agreement serves the public interest.

We do not find that approval of the settlement is in the public interest, as we set forth in detail below.

A. ***Oversight of utility accounting practices.*** The Commission is obligated as part of its regulatory function to inquire into the management of the business of all utilities within its jurisdiction, which of necessity includes the obligation to inquire into the accounting methods of a given utility. I.C. §8-1-2-48. As such, the Commission has authority to determine the accounting for regulated entities, and as long as it is within reason, courts may not interfere with the Commission's exercise of that power. *N. Ind. Pub. Serv. Co. v. Ind. Office of Util. Consumer Counselor,* 826 N.E.2d 112, 118 (Ind. App. 2005.) In examining such a decision, the main issue is

not consistency with prior Commission orders, but whether there is sufficient evidence of record to support the decision. *Id.* at 119.

The Commission prescribes all forms of accounting, and utilities must keep their books and records accordingly. I.C. §8-1-2-12. The Commission "shall provide for the examination and audit of all accounts[,]" and Commission employees or agents working under the direction of the Commission have the right to inspect all books and records of a utility. I.C. §§8-1-2-17, 8-1-2-18. Utilities are required to keep uniform accounts of all business transacted, and the Commission may refer to any system of accounts authorized by law or national entities in reviewing those accounts. I.C. §8-1-2-10. Specific to this case, sewage utilities are required to keep their books in a manner consistent with NARUC USoA standards. 170 I.A.C. 8-2-1.

LMH provided service, charged rates, and obtained financing for three years in the absence of Commission approval, and its first rate case was initiated by Commission order. Public's Ex. 1, p. 7. By the time of Cause No. 40004, LMH's irregular accounting practices resulted in a specific finding and agreement by LMH that it would keep its books pursuant to NARUC's USoA. The evidence of record in this cause shows that LMH's books and records are in such disarray that the OUCC witnesses referred to them several times as totally unreliable. Public's Ex. 1, p.1, lines 17-20; p.10, lines 2-6. Initially, the OUCC recommended that LMH only be granted a 3.4% increase, representing the interest on certain outstanding third-party debt. Public's Ex. 1, p. 12. The OUCC's direct testimony expressed serious concerns based on LMH's history of accounting irregularities and the significant inconsistencies in the evidence in this case. Public's Ex. 1, pp. 5-11. Ms. Gemmecke noted that as far back as 1989, filings indicated significant payments to shareholders, at the same time that substantial financial issues were also present. Public's Ex. 1, p. 9, lines 1-10. In Cause No. 39104, LMH's first rate case, its books and records were declared by the OUCC to be "insufficient" for the purpose of establishing rates; Ms. Gemmecke stated that the only thing that has changed since that time are the numbers. *Id.*, lines 11-21.

Ms. Gemmecke noted in her testimony offered to "discuss"[8] the settlement that "[d]epreciation expense could not be calculated due to severe inaccuracies in [LMH's] records." Public's Ex. 4, Sched. 3, p. 1. Nonetheless, the parties included depreciation as part of the settlement's rate increase of 15%. Even with the provision that such interim rates are subject to refund, Ms. Gemmecke's testimony undermines the requirement that all elements of a settlement be supported by probative evidence. If LMH's depreciation could not be calculated due to severe inaccuracies in its records, it cannot represent probative evidence in support of even an interim rate. The accounting evidence of record does not support the settlement's calculation, and therefore cannot be evidence in support of approval of the settlement by the Commission.

B. Financing. Utilities may not "sell, assign, transfer, lease, or encumber" the utility franchise, works, or system without prior approval from the Commission. I.C. §8-1-2-83. In addition, a utility may "incur indebtedness payable at periods of more than twelve months only with Commission approval." *In the Matter of a Commission Investigation Upon Its Own Motion Regarding Operation of Utility Center, Inc.'s Water and Sewage Treatment Facilities,* Cause No.

[8] Ms. Gemmecke's testimony in Public's Ex. 4 is not captioned as support for the settlement; the stated purpose of her testimony is to "discuss" the settlement. Ms. Gemmecke does, however, state that it is in the public interest to include depreciation in the interim rates so that LMH can "reinvest that return into the plant by performing necessary replacement for aging infrastructure." Public's Ex. 4, p.2, lines 8-19.

41187, 1999 Ind. PUC LEXIS 12, at *97 (Ind. Util. Regulatory Comm'n, Feb. 25, 1999); I.C. §8-1-2-78. The purpose of these related provisions is to protect the public by ensuring that the terms of any long-term financing are reasonable. As the Commission has previously noted:

> It would be inconsistent with the intent and purpose of [I.C. §8-1-2-78] if a public utility could circumvent its approval requirement for the borrowing of funds that clearly could not be repaid in less than a year simply by entering into a one year renewable note and then extending the repayment period indefinitely by renewing the note at the end of each year.....[The] failure to seek approval for capital expenditures in excess of $10,000 means that the capital items may not, without justification, be included in [a utility's] rate base at its next rate hearing.

Utility Center, 1999 Ind. PUC LEXIS 12 at *98.

Similarly, the requirements of Indiana Code §8-1-2-79 state:

> Whenever a public utility desires to issue bonds, notes or other evidences of indebtedness, payable more than one (1) year from the execution thereof, or preferred or common stock, it shall file with the Commission a petition verified by its president or vice-president, and secretary or assistant secretary, or by two (2) of its incorporators, if it has no such officers, setting forth: (1) the principal amount of bonds, notes, or other evidences of indebtedness, and the par value or number of shares of preferred and common stock; (2) the minimum price for which said securities are to be disposed of or sold; (3) the purposes for which said securities are to be disposed of or sold; (4) the description, cost, or value of any property acquired or to be acquired from the proceeds of the disposal or sale of said securities; (5) a balance sheet and income account; and (6) all other information that may be relevant or that may be required by the Commission. For the purpose of enabling it to determine whether the proposed issue is in the public interest, in accordance with laws touching the issuance of securities by public utilities, and reasonably necessary in the operation and management of the business of the utility in order that the utility may provide adequate service and facilities, the Commission also may consider the total outstanding capitalization of the utility, including the proposed issue, in relation to the total value of or investment in the property of the utility, including the property to be acquired by the proposed issue, as shown by the balance sheet, accounts, or reports of the utility, the records of the Commission, or other evidence, and the character and proportionate amount of each kind of security, including the proposed issue, and the unamortized discount suffered by the utility in the sale of the outstanding securities. The Commission shall make such further inquiry or investigation, hold such hearing or hearings, and examine such witnesses, books, papers, documents, or contracts as it may deem of importance in enabling it to reach a decision. (b) An owner, officer, or agent of any public utility who knowingly violates this section, or knowingly makes any material misrepresentation or misstatements in connection with this section, commits a Class D felony.

As set forth in the procedural history above, this case is not the first instance in which the Commission has had cause to scrutinize LMH's borrowing practices. As far back as 1993, Jerry Tucker, (then-President, and now-Director of LMH) stated that he was unaware of the utility's

obligation to seek pre-approval for financing; the Commission excused that failure on the grounds of exigent circumstances, and approved the financing retroactively. *In the Matter of the Petition of L.M.H. Utils. Corp.,* Cause No. 39104, 1993 Ind. PUC LEXIS 8 (Ind. Util. Regulatory Comm'n Jan. 20, 1993.) Thus, apart from its free-standing obligation to be aware of, and to comply with, statutory strictures, LMH has been explicitly aware of the need to obtain prior approval for financing for at least fourteen years.

Subsequently, LMH did not seek prior Commission approval for its 2002 shareholder loan to Jay Tucker, LMH's current President. As noted by OUCC witness Mr. Kaufman, the principal payments on a shareholder loan are analogous to a repurchase of common stock; the interest payments are analogous to a dividend payment. This permits the owners to withdraw money from the utility without repurchasing common stock or declaring dividends. Thus, as Mr. Kaufman testified, the owners of a utility with a negative equity balance can continue to withdraw funds from a financially distressed utility through the repayment of a shareholder loan, with payments charged as an expense and not a dividend payment. Public's Ex. No. 3, pp. 8-9. LMH paid $2,991.38 per month on its shareholder loan during the last twelve months, for a total of almost $36,000. Public's Ex. 3, p. 9, lines 14-21. This is despite the fact that LMH has an equity balance of only $32,095 in its capital structure[9], and, according to its exhibits, lost $39,314 in 2005 (excluding interest and subsequent connector income). Mr. Kaufman testified, and we agree, that a utility in such a financial distress should not be paying its owners "interest" (dividends) on a shareholder loan. *Id.* Such evidence would have no doubt been examined, had LMH sought the requisite Commission approval.

These concerns carry over to the issue of long-term third-party financing. Upon the filing of its original petition in this matter, LMH sought approval for $750,000 of long-term financing. It then sought expedited approval for the same sum on August 2, 2006, stating the need to pay contractors for work in progress. On August 4, 2006, even before the allowed time for response by the OUCC, LMH had already obtained the $750,000 via a short term loan. Public's Ex. 3, p. 5, line 5-9. According to the testimony of OUCC witnesses, LMH had already expended most of the $750,000 by the time of the evidentiary hearing on December 8, 2006.[10] Ms. Gemmecke testified that the short term financing had been guaranteed by LMH's owners, and that the utility did not currently have the ability to repay the loan. Tr. at A-38, lines 8-24. She also noted that LMH intended to roll over the $750,000 short-term debt into long term financing. *Id.*

The settlement agrees to include the $750,000 debt service in the Phase II rates. Petitioner's Ex. 4, p.4, ¶i. We decline to accept this provision in the absence of any Commission review of the proposed plant, the financing, and the contractors to whom payment has been, or will be, made. Taken together, we find that LMH's failure to obtain approval *before* securing the $750,000 financing is another reason that settlement of this matter is not in the public interest.

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[9] This amount is in contrast to Petitioner's Ex. 4, Exhibit A, which reflects shareholder equity of $7,179.

[10] LMH has not filed any documentation showing how the short-term loan funds were disbursed, and the evidence regarding "costs" for the plant expansion have been summaries. LMH's engineer did not provide detail as to the cost or components of the plant expansion. See, Petitioner's Ex. 3. Similarly, Mr. Tucker did not provide such detail in his testimony. LMH's responses to the OUCC's discovery requests regarding the costs associated with the plant expansion consisted of a half-page chart with summary prices. See, Public's Ex. 2, Attachment HLR 3, pp. 1-2.

C. Rate determinations and the determination of test year. In every rate proceeding, the Commission must establish rates and charges that are sufficient to allow the utility to meet its operating expenses, plus provide a return on investment to compensate investors. *L.S. Ayres & Co., v. IPALCO,* 169 Ind. App. 652, 657, 351 N.E.2d 814, 819 (Ind. App. 1976.) If the Commission correctly performs its regulatory judgment function in ratemaking, it "must examine every aspect of the utility's operations and the economic environment in which the utility functions to ensure that the data it has received are representative of operating conditions that will, or should, prevail in future years." *City of Evansville v. S. Ind. Gas & Elec. Co.,* 167 Ind. App. 472, 482, 339 N.E.2d 562, 570-71 (Ind. App. 1975.) The Commission can make a rate determination in more than one way, and a utility has no right to insist that the Commission follow a certain process in its ratemaking methodologies. *Citizens Action Coalition of Ind., Inc. v. Pub. Serv. Co. of Ind.,* 571 N.E.2d 1270 (Ind. App. 1991.)

Crucial to any rate determination is the selection of a test year, which is "normally the most recent annual period for which complete financial data [is] available[.]" *City of Evansville v. S. Ind. Gas & Elec. Co.,* 167 Ind. App. 472, 478, 339 N.E.2d 562, 568 (Ind. App. 1975.) The test year model assumes that the operating results during the period chosen "are sufficiently representative of the time in which new rates will be in effect to provide a reliable testing vehicle for new rates." *Id.* The rate base is generally described as that property "used and useful" in providing a given utility service. *City of Evansville,* 339 N.E.2d at 569. "[R]ate base, expense and revenue data for an historical test year are meaningful for a determination of utility rates only insofar as past operations are representative of probable future experience." *City of Evansville,* 339 N.E.2d at 575. Adjusting test-year figures to include changes that have occurred or will occur after the end of the test year may be insufficient to show a true picture when the test-year data are fundamentally unrepresentative. *Id.* If test year results are unrepresentative, adjustments may be necessary to account for changed conditions not reflected in test-year data. *L.S. Ayres,* 351 N.E.2d at 820. Such adjustments are either "in-period" (to reflect unusual conditions during the test year) or "out-of-period adjustments" (for such items as known future wage or tax increases.) *L.S. Ayres,* 351 N.E.2d at 820.

A reasonable test year is determined by:

> taking the actual results for the particular test year and adjusting for any extraordinary and nonrecurring items and for all known and measurable changes. The test year sets the limits by which the factors of rate-making can be known and used for the rate-making process. As a general rule, it does not take into consideration future expenses or future revenues except known changes in both expenses and revenues occurring within reasonable proximity to the test year. The object of the test year is merely to reflect typical operating conditions of a utility and provide a reliable guide in fixing rates for the future by monitoring actual operating results over a representative period of time.

Capital Improvement Bd. Of Mgrs. Of Marion County, v. Pub. Svc. Comm'n, 176 Ind. App. 240, 375 N.E.2d 616, 630 (Ind. App. 1978.)

As part of the Commission's overall regulatory responsibilities regarding rate determinations, we must establish if the chosen test year is appropriate to the facts and circumstances of the case. Ultimately, this leads us to the question of whether the rates achieved

under a given test year meet the requirement of being "reasonable and just." There must be evidence of record to show that the test-year decision was proper under the facts and circumstances before us. *City of Evansville,* 339 N.E.2d at 577. This decision must balance between a rigid adherence to a test year devoid of any predictive value, and an allowance of excessive adjustments that creates an unreliable result. *Capital Improvement Bd. of Mgrs.*, 375 N.E.2d at 638. The Commission's ratemaking decisions cannot be based upon speculation or a hypothetical expense. *S. Haven Waterworks, Corp., v. Ofc. Of Util. Consumer Counselor,* 621 N.E.2d 653, 655 (Ind. App. 1993).

In support of the proposed rate increase, Mr. Sommer's direct testimony stated that LMH's rates were insufficient and that an increase was necessary to provide safe and adequate service to its customers. More specifically, he stated that the rate increase was necessary so that LMH could implement a more systematic maintenance program in response to IDEM dictates. Petitioner's Ex. 4, p 4. He based his analysis on the initial test year of December 31, 2005, as originally agreed to in the prehearing conference order.

Subsequently, LMH requested a modification of the test year to December 31, 2006, a request opposed by the OUCC and ultimately denied by the Presiding Officers. The record shows that LMH did not appeal that ruling by the Presiding Officers. Nonetheless, the settlement offered by LMH and the OUCC contains a new test year of December 31, 2006 for the proposed Phase II of the rate case. This highly unusual procedural stance asks us to accept the test year as agreed to by the parties, despite a ruling to the contrary by the Presiding Officers. Irrespective of procedure, however, there are other issues that concern us.

The determination of a test year is a matter committed to the Commission's judgment. It is altogether unclear whether the test year as agreed represents a representative picture of LMH's business, even after restatement of its books. As we noted above, the modification of the test year as agreed to by the parties is also a violation of I.C. §8-1-2-42(a). Utilities may not file a request for a rate increase within fifteen months after the filing of its most recent rate request, except in limited circumstances, none of which apply here. The parties offer no relevant authority supporting the use of two different test years in the course of one phased rate proceeding.

Second, the request to use the modified test year is specifically premised on the desire to include the newly constructed plant. This plant is one that LMH never applied for, or received, approval from the Commission to build. Therefore, we cannot with any confidence say that the plant in question is 'necessary', 'used,' or 'useful', as is required. In the absence of those crucial findings, we decline to accept the modification to the test year and the inclusion of the expanded plant in rate base.

Third, the rate settlement represents a compromise between the parties' original positions, but that compromise is based on extremely unstable financials. The OUCC originally recommended a 3.4% increase, enough only to cover the interest on LMH's third-party debt. Mr. Sommer stated that the settlement was in the public interest because it would provide LMH with an interim rate increase while the books and records were put in order, and that the settlement also protected the public from unreasonable rates and charges. Petitioner's Ex. 5, pp. 2-3. He further stated that the interim rates were supported by LMH's accounting records. *Id.*

However, Mr. Sommer did not provide specific evidence in support of these assertions. We can accept as true that a 15% increase is less than a 54% increase. Nonetheless, any increase must have evidence of record to support it. Agreeing that the rates are subject to refund does not negate the need for probative evidence to support the rates in the first instance. We cannot grant a rate increase, even if interim, in the absence of probative evidence.

We also decline to grant the interim 3.4% increase as suggested by the OUCC in its direct testimony, as a result of the significant accounting irregularities. Most of the expense that the 3.4% increase is designed to cover is the anticipated interest expense on the short-term debt. See, Public's Ex. 1, Sched. 1, p.1, Sched. 5. p.1.[11] As in the past, LMH failed to obtain Commission approval before entering into debt. See, *In the Matter of the Petition of L.M.H. Utils. Corp., supra,* Cause No. 39104, 1993 Ind. PUC LEXIS 8; *Petition of L.M.H. Utilities, Corp. for approval of Expansion of Its Certificate of Territorial Authority, supra,* Cause No. 40004, 1995 Ind. PUC LEXIS 207 (LMH obtained financing prior to approval of final order).

The test year as proposed by the settling parties violates statutory mandates. The parties have not offered relevant precedent to support the substitution of a different test year. In addition, an interim rate must still have probative evidence to support it. In the absence of prior Commission review of, and approval for, the short-term debt, we will not grant the 3.4% rate increase originally suggested by the OUCC.

D. Determinations of capital as part of a utility's rate base; Contributions in Aid of Construction ("CIAC"). A utility's rate base is determined by adding the net investment in physical properties to an allowance for working capital. *L.S. Ayres,* 351 N.E.2d at 820. While utilities may incur any expense they so choose, the Commission may also exclude expenditures from the rate base if it deems the expenses to have been imprudently incurred. *City of Evansville,* 339 N.E.2d at 569. To be included in rate base, utility plant must be both "used and useful" and "reasonably necessary" to the provision of utility service during the test year. *City of Evansville,* 339 N.E.2d at 590. To determine necessity in this context, the used and useful property needs to be employed to produce the product or accommodation that rate payers receive. *Ind. Gas Co., Inc. v. Office of Util. Consumer Counselor,* 675 N.E.2d 739, 743 (Ind. App. 1997.)

After a determination is made as to 'used and useful' and 'necessary' capital improvements, the Commission must also determine the cost of capital. The cost of capital calculation is based on an examination of the cost of debt, preferred stock, and common stock; the composite cost of capital is calculated by taking a weighted average of the cost of each capital component. *City of Evansville,* 339 N.E.2d at 570. Therefore, an accurate rate calculation must combine a review of capital improvements, the sources of funding for those capital improvements, and the cost of that funding. This composite, when stated as a percentage of the utility's combined debt and equity accounts, is then compared with the utility's existing rate of return, and acts as the reference for a fair rate of return. *City of Evansville,* 339 N.E.2d at 570. A typical utility might be comprised of 50 percent debt, 15 percent preferred stock, and 35 percent common stock. *City of Evansville,* 339 N.E.2d at 569.

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[11] The total interest expense as calculated by Ms. Gemmecke for inclusion in the proposed 3.4% increase was $71,978. See, Public's Ex. 1, Sched. 1, p.1, Public's Ex. 1, p. 11, lines 9-17. Of that, the calculation of the anticipated interest expense for the short-term debt, obtained in August 2006 without Commission approval, was $61,875. See, Public's Ex. 1, Sched. 5.

Generally, utility company shareholders, not consumers, furnish the capital necessary for the operation of the utility. *City of Evansville,* 339 N.E.2d at 585. The consumer pays a rate that covers a fair return on the utility's capital and the cost of operation. *City of Evansville,* 339 N.E.2d at 585. Consistent with the precept that shareholders, not consumers, are responsible for capital contributions to a utility is the Indiana Supreme Court's declaration that customer contributions in aid of construction ("CIAC") cannot be included in the fair value of property upon which the utility's rate is determined. *City of Evansville,* 339 N.E.2d at 585. citing *Pub. Svc. Comm'n v. City of Indianapolis,* 235 Ind. 70, 93, 131 N.E.2d 308, 317 (1956); *accord, Office Of Util. Consumer Counselor v. Pub. Serv. Co. of Ind.*, 449 N.E.2d 604 (Ind. App. 1983.) The exclusion of CIAC from the rate base is founded in the maxim that to be included, the property must be 'used and useful for the convenience of the public.' "Because the construction work in progress is not included in the rate base, the customer is not paying any return on the investment." *Citizens Action Coalition of Ind., Inc. v. Pub. Serv. Co. of Ind., Inc.,* 552 N.E.2d 834, 840 (Ind. App. 1990), *reh'g denied* (citations omitted.)

Implicit in the definition of CIAC is that such funds are donations provided at no cost to a given utility. *S. Haven Waterworks,* 621 N.E.2d at 655; see also I.C. §§8-1-2-10, 8-1-2-12, 170 I.A.C. 8-2-1. Inclusion of CIAC in a utility's rate base is prohibited under I.C. §8-1-2-6. *Ind. Office of Util. Consumer Counselor v. Lincoln Utils., Inc.,* 784 N.E.2d 1072, 1077 (Ind. App. 2003)("Lincoln Utils. I") To include CIAC would violate the axiom that a utility cannot "earn a return on property in which it has made no investment." *Lincoln Utils. I,* 784 N.E.2d at 1077. I.C. §8-1-2-6(b) states that "[no] account shall be taken of construction costs unless such costs were actually incurred and paid as part of the cost entering into the construction of the utility." *Ind. Office of Util. Consumer Counselor v. Lincoln Utils., Inc.,* 834 N.E.2d 137, 143 (Ind. App. 2005) ("Lincoln Utils. II.") Even where the inclusion of CIAC may make good economic sense, "the statute must permit the inclusion of such before the [Commission] is authorized to do so." *Lincoln Utils. II,* 834 N.E.2d at 145. If the Commission were to include CIAC in the fair value of a utility, the Commission would exceed its statutory authority. *Lincoln Utils. II,* 834 N.E.2d at 145. Such CIAC amounts paid by a utility's customers are obligations that the utility owes to its customers, the same as any other debt. *Gary-Hobart Water Corp. v. Ind. Util. Regulatory Comm'n,* 591 N.E.2d 649, 654 (Ind. App. 1992).

The OUCC originally recommended that interim rates be ordered, based on a non-traditional ratemaking methodology. As Ms. Gemmecke noted, including the requested $750,000 debt in rates would require that the debt be recorded as CIAC. However, with little or no investor-supplied plant, the OUCC was very concerned that LMH did not have adequate rate base to financially sustain the utility. Public's Ex. 1, p.11-12, p. 24, lines 2-12. Mr. Kaufman expressed his concerns that LMH's proposed debt of $750,000 would result in a debt-to-equity ratio for LMH of 96.84% debt and 3.16% equity. Public's Ex. 3, p.2. This skewed ratio is a fact that even LMH's witness acknowledged. *See*, Petitioner's Ex. 4, Sommer Testimony at p. 5, lines 5-7. Mr. Kaufman noted that based on some calculations made by Ms. Gemmecke, it was possible that LMH had a negative equity ratio. Public's Ex. 3, p. 3. Mr. Kaufman testified that a capital structure for a utility similar to LMH would be an investor-supplied equity ratio of between 43.0% and 54.0%, with an average equity ratio of 48%. Based on the sample he examined, the lowest equity rate is 38%, and the highest is at 57%; these are considered reasonable equity ratios for water utilities. Petitioner's Ex. 3, p. 2. He stated that when a utility's investor-supplied equity falls below 25%, corrective action should be taken. *Id.* at pp. 4-5. Without investor-supplied capital, it is difficult to calculate a rate of return, and Mr. Kaufman testified that when ratepayers pay for rate base, the utility should not be

allowed to earn a return on the rate base. *Id.* at p.7-8. This is one of the reasons underlying Mr. Kaufman's belief that the $750,000 loan should be characterized as CIAC. *Id.* He stated that LMH needs to have both a positive equity and positive rate base, which will only happen if LMH's shareholders invest equity into the company and use the equity to add rate base. *Id.* at p. 8, lines 7-13. For all these reasons, Mr. Kaufman recommended against approval of LMH's proposed debt. *Id.* at pp. 4-5.

At the core of this conundrum regarding CIAC is the highly variable amount of LMH's Utility Plant in Service ("UPIS.") LMH's test year UPIS shown on its Balance Sheet as of December 31, 2005 was $1,185,101. Petitioner's Ex. 4, Exhibit A. An examination of LMH's Exhibit D, excluding LMH's proposed project, shows UPIS as of December 31, 2005 at $3,112,729, a $1,927,628 increase. LMH's work papers do not support these adjustments. Further, neither of these UPIS balances agree with the UPIS balance of $1,494,906 contained in LMH's 2005 IURC Annual Report, as noted by Ms. Gemmecke in her testimony. Public's Ex. 1, pp. 4-5. In addition, it appears that LMH made no adjustments to the equity section of the balance sheet to reflect the increased investment in utility plant. Without a clear determination of CIAC and UPIS, a rate calculation will be hypothetical, an outcome that is clearly forbidden. *S. Haven Waterworks, Corp., v. Ofc. Of Util. Consumer Counselor,* 621 N.E.2d 653, 655 (Ind. App. 1993).

Ms. Gemmecke's original recommendations used LMH's outstanding debt as a proxy for a reasonable rate of return, and essentially gave LMH the benefit of the doubt in assuming that it was 100% debt financed. Therefore, this led to Ms. Gemmecke's conclusion that the reasonable rate of return for LMH is the interest on its outstanding third-party debt[12]. Mr. Kaufman noted that until LMH's books and records can be fully assessed, any capital structure is purely hypothetical, "and should not be used to determine rates." Public's Ex. 3, p.6, lines 18-21.

We have no clear picture of how much of LMH's current plant was funded with CIAC. In addition, inclusion of the short-term debt would exacerbate the current skewed state of LMH's debt-to-equity ratio. We therefore cannot accept the parties' settlement of these issues.

E. Approval required for the construction of utility plant. A bedrock principle of Commission oversight is the obligation to keep itself informed regarding a utility's construction of plant pursuant to I.C. §8-1-2-23. In reviewing the additions and expansions of plant proposed by a utility, the Commission must show specific findings of fact to support its determination. *L.S. Ayres v. Indianapolis Pwr. & Light, Co.,* 169 Ind. App. 652, 351 N.E.2d 814 (1976.) Not only must a utility inform the Commission of its plans to build new plant, but it must also seek, and obtain, approval before beginning such work. The statute states:

> Unless a public utility shall obtain the approval by the commission of any expenditure exceeding ten thousand dollars ($10,000) for an extension, construction, addition or improvement of its plant and equipment, the commission shall not, in any proceeding involving the rates of such utility, consider the property acquired by such expenditures as a part of the rate base, unless in such proceeding the utility shall show that such property is in fact used and useful in the public service; Provided, That the commission in its discretion may authorize the expenditure for such purpose of a less amount than shown in such estimate.

[12] This includes the short-term debt that has not been approved by this Commission.

I.C. §8-1-2-23.

The Commission recently had occasion to reiterate that under certain circumstances, "[w]e have preapproved rate base additions pursuant to Section 23 ...for the reasonable cost of reasonably necessary system improvements and additions." *Verified Petition of Indiana Gas Co., Inc. d/b/a Vectren Energy Delivery of Indiana for Approval of a Gas Service Contract with Honda Mfg.,* Cause No. 43098, 2006 Ind. PUC LEXIS 380, at *30-31(Ind. Util. Regulatory Comm'n Dec. 13, 2006). (*citing American Suburban Utilities, Inc.,* Cause No. 41254, p. 14 (Ind. Util. Regulatory Comm'n Apr. 14, 1999.)[13] The Commission noted that two questions underlie a request for pre-approval under 8-1-2-23 – "whether an expenditure of any amount is reasonably necessary to assure reasonable and adequate service, [and] [i]f so, [w]hat amount reasonably needs to be invested[.]" *Id.* at *31.

Quite apart from its free-standing obligation to seek pre-approval for plant expansion, as part of the settlement agreement in Cause Number 40004, LMH was specifically ordered to seek bids and obtain Commission approval for any project with a budget over $10,000. In this case, LMH did not seek pre-approval of the expansion that it now seeks to fund with its proposed $750,000 financing. While LMH has cited the need for expansion of its plant due to expected growth in the area, that growth is anticipated by Mr. Tucker to occur in the next five to seven years. Petitioner's Ex. 2, p. 1. Mr. Rees's calculations regarding plant exhaustion did not match those proffered by LMH; Mr. Rees calculates plant exhaustion in 2016. Public's Ex. 2, pp. 4-5. As such, there does not appear to be any reason why LMH could not seek pre-approval before embarking on plant expansion. By the clear terms of I.C. §8-1-2-23, the Commission would be fully within its statutory purview to reject the plant expansion for failure to comply with statutory mandates.

We also have concerns about the evidence of record regarding the current state of LMH's system. Mr. Rees stated that "most" homes served by LMH have their sump pumps attached to LMH's system, and stated that "developer" practices were primarily responsible for these connections. Public's Ex. 2, p.3, lines 6-12. This is a direct violation of 170 I.A.C. 8.5-1-2(c), which states that sewage disposal companies are not to receive water from sump pumps. We are therefore concerned as to whether new plant is in compliance with applicable regulations, as we have not been presented with the opportunity to pass judgment on them, or with any efforts or plans to remedy this violation. It is also unclear whether the plant expansion would be needed if "most" of LMH's customers did not empty their sump pumps into LMH's system.

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[13] That order also cited substantial additional authority for this precept. *E.g., Indiana-American Water Company,* Cause No. 41692, pp. 7-8 (IURC 11/8/2000) (replacement Lake Michigan water intake tunnel); *Wimberly Sanitary Works, Inc. and Country View Sewage Plant, Inc.*, Cause No. 42173, pp. 7-9 (IURC 9/4/2002) (wastewater treatment plant expansion project); *Northwest Indiana Water Co. and Peoples Water Co.*, Cause No. 41322, p. 5 (IURC 2/3/1999) (interconnection with a utility system being acquired); *Indiana-American Water Co. and Farmington Utilities, Inc.*, Cause No. 40442, p. 6 (IURC 10/2/1996) (expenditures to improve a utility system being acquired); *Indiana Gas Co. and Westport Natural Gas Co.*, Cause No. 38302, p. 18 (IURC 1/20/1988) (expenditures to acquire another utility system). *Compare Utility Center Inc.,* Cause No. 41187, p. 34 (IURC 2/25/1995) (reminding the utility that failure to seek pre-approval could subject rate base additions to disallowance); *Indianapolis Power & Light Co.*, Cause No. 39437, p. 6 (IURC 3/5/1993) (suggesting that Section 23 would authorize pre-approval of IPL's pollution control property and proposed ratemaking treatment even without other more specific statutes).

We also note the variable cost estimates for the project. Mr. Sommer's estimate for the project is $1,142,581. Petitioner's Ex. 4, Ex. D. However, this does not match the estimate proposed by Mr. Tucker of $950,000 (Petitioner's Ex. 2, p. 2) or that provided to the OUCC and attached to Mr. Rees's testimony ($1,155,000.) Public's Ex. 2, p.5, lines 14-16. The NPDES permit attached to Petitioner's Ex. 2 states the estimated cost of the project at $500,000. Petitioner's Ex. 2, Ex. JT-3, Checklist for Construction Project, Design Summary, no. 7. All of these issues inform our concerns regarding the plant currently being built. In the absence of a full review of the plant additions, we have no assurance that the installation of the plant was necessary, and that the resulting plant constitutes used and useful property.

F. Affiliate contracts. The Commission has the power to inquire into businesses determined to be affiliated interests under I.C. §8-1-2-49, "to the extent of access to all accounts and records of joint and general expenses." *Id.* These statutory constraints are part of the Commission's oversight role to protect the public interest. The Commission must review affiliate contracts, and no such contract is valid until it is filed with the Commission. The power to disapprove such contracts "can prevent cross-subsidization of non-utilities by ratepayers. The burden is on the utility to justify inclusion of affiliate-based costs in its rate base." *Midland Cogeneration Venture Ltd. P'ship v. Mich. Pub. Serv. Comm'n,* 199 Mich.App. 286, 324, 501 N.W.2d 573, 591 (Mich. Ct. App. 1993); *accord, City of Ft. Wayne, Ind. v. Util. Ctr., Inc.,* 840 N.E.2d 836, 842 (Ind. App. 2006) (onus is on utility to provide evidence that the affiliate contracts are in the public interest.) Such cross-subsidization can result in intracorporate transfers that artificially inflate or deflate a utility's financials, resulting in rates that "do not accurately reflect the cost to or gain by the utilities, the affiliates, or their common owners....If successful, the utility will be able to charge higher rates, with the extra profit going to its shareholders while its customers pay $3 for a $2 item." *GTE Northwest Inc., v. Pub. Util. Comm'n of Ore.,* 120 Ore. App. 401, 404, 852 P.2d 918, 920 (Ore. Ct. App. 1993); *accord, State ex rel. Atmos Energy Corp. v. Pub. Serv. Comm'n,* 103 S.W.3d 753, 763-64 (Mo. 2003). The Commission disapproves of such cross-subsidization. *See, Re: White River Valley Water Corp.,* Cause No. 40719, 1998 Ind. PUC LEXIS 1, at *45 (Ind. Util. Regulatory Comm'n Jan. 7, 1998.)

As noted by the OUCC, NARUC's guidance for cost allocations and affiliate transactions states that "allocation methods should not result in subsidization of non-regulated services or products by regulated entities unless authorized by the jurisdictional regulatory authority." NARUC went on to state the following:

> First, affiliate transactions raise the concern of self-dealing where market forces do not necessarily drive prices. Second, utilities have a natural business incentive to shift costs from non-regulated competitive operations to regulated monopoly operations since recovery is more certain with captive ratepayers. Too much flexibility will lead to subsidization. However, if the affiliate transaction pricing guidelines are too rigid, economic transactions may be discouraged.

Public's Ex. 1, pp. 19-20.

Consequently, NARUC recommends that the price for services, products and the use of assets provided by a non-regulated utility to a regulated affiliate be either the lower of fully allocated cost, or prevailing market prices. *Id.*

LMH has contracts with several affiliates, as noted by Petitioner's Ex. 2, the testimony of Mr. Tucker, LMH's president. That testimony contained contracts between LMH and the following affiliates: Jet Enterprises, Inc., consisting of a lease for $500 per month for office space (Exhibit JT-4); Tucker Homes, Inc., assessing LMH's *pro rata* share of office materials at cost (Exhibit JT-5); and Utility Construction Corp., which was a contract to perform, from time to time, operation, maintenance, testing and construction services to LMH (Exhibit JT-6.) These contracts have not been reviewed by the Commission.

The Commission previously approved an affiliated interest agreement between affiliates LMH and Tucker Homes in Cause Number 39104. That agreement, dated May 31, 1991, was for the rental of office space, sewage maintenance extension services, tap-ons and other similar services to LMH on an on-going basis. The Commission noted in granting its approval of these contracts that "services and materials are to be provided to [LMH] at cost and that no profit is to be made by either affiliated interest from transactions with [LMH.]" *In the Matter of the Petition of L.M.H. Utils. Corp.*, Cause No. 39104, 1993 Ind. PUC LEXIS 8, at *14.

The OUCC stated that while no prices were listed in the affiliate contracts in this cause, LMH's evidence showed that it paid its affiliates $14,975 a month to perform services for LMH. Public's Ex. 1, p. 16-17. LMH paid more than $170,000 to its affiliates during the test year. Public's Ex. 1, p. 19, lines 6-9. The agreement between UCC and LMH states that UCC will provide services "with a price which is no greater than the price that UCC would typically charge to any other customer for similar work." Petitioner's Ex. 2, Ex. JT-6. This contrasts with the affiliate contract approved by the Commission, which provided services at cost. Ms. Gemmecke noted that the bill from UCC to LMH is "a lump sum monthly fee and the contract does not state what is required of UCC." Public's Ex. 1, p.18-19.

As noted by Mr. Kaufman, LMH has been paying UCC for the performance of monthly services such as testing and sludge pressing. However, other evidence of record indicates that IDEM cited LMH for a failure to maintain documentation of the entity performing testing. Public's Ex. 2, p.6, lines 8-15.[14] The fact that IDEM has ordered LMH to maintain such documentation has been used as a partial support for LMH's request for a rate increase; Mr. Sommer cited a need to perform more systematic maintenance in response to IDEM dictates. Petitioner's Ex. 4, p. 3, lines 10-12. LMH's evidence states that UCC was performing the testing for LMH; the evidence also states that proper test documentation was not maintained pursuant to IDEM rules. Petitioner's Ex. 2, Ex. JT-6.

So, even after LMH paid $1,600 per month to UCC to meet LMH's testing obligations, LMH did not have appropriate documentation to remain in compliance with IDEM. Public's Ex. 1, p.18, line 21. Ms. Gemmecke noted that no testimony was provided to support the current cost of testing, "let alone the basis for the increased cost of performing such test." Public's Ex. 1, p. 18, lines 18-21. In the absence of underlying cost data, and in the presence of IDEM violations, we concur with the OUCC that additional review is necessary of the allocated costs and prices for the services provided by LMH's affiliated contracts.

[14] Mr. Rees' testimony contains a quote from the IDEM report citing LMH's deficiencies that LMH was "not reporting the person who is performing the sampling or measurements, or the person who is performing the analysis." Public's Ex. 2, p. 6, lines 11-15.

*G. **Commission oversight of the System Development Charge.*** Once the Commission approves a utility's rates, the utility must file its tariff "showing *all* rates, tolls and charges which it has established and which are enforced...for any service performed by it within the state, or for any service in connection therewith...." I.C. §8-1-2-38 (emphasis added.) The Commission's approval of the tap-on charge in LMH's first rate case noted that it was supported by "evidence of actual expenses associated with" connections made to LMH's system, and that LMH was thereby authorized to impose *only* the tap-on charge of $625.00. *In the Matter of the Petition of L.M.H. Utils. Corp.,* Cause No. 39104, 1993 Ind. PUC LEXIS 8, at *9.

In this case, LMH originally requested an SDC of $3,000 for each equivalent 5/8" – ¾" water meter installation, with larger meter sizes paying proportionally larger fees. Mr. Sommer stated that LMH needed this SDC to help finance future capital improvements. He further testified that the proposed SDC is not justified for LMH under either the equity buy-in or incremental cost method as set forth by the American Water Works Association ("AWWA"). This is as a result of LMH's financing of its planned project and the fact that existing plant has been financed primarily with CIAC and debt. Mr. Sommer thus proposed that if the Commission were to authorize collection of the SDC, LMH will segregate this money into an account to be used solely to finance future capital improvements, which may obviate the need for the next rate increase. Petitioner's Ex. 4, p. 7.

According to prefiled testimony, LMH began charging the SDC (which has also been dubbed a "developer fee") in 2001. Since that time, according to Ms. Gemmecke's calculations, LMH has collected a total of $495,050 in such fees through 12/31/05. Public's Ex. 1, p. 8, lines 1-3. The OUCC recommended that a marginal or incremental approach to calculating LMH's SDC be taken. Based on LMH's projections, the OUCC assumed that the cost of the planned expansion at $1,142,000, with an expanded capacity of an additional 180,000 GPD. Public's Ex. 1, pp. 23-26. The OUCC then used IDEM's standard measure of 310 GPD per EDU, for a total of 580 additional EDUs. Dividing the $1,142,000 cost by the number of additional customers it is designed to serve (580), results in an SDC of $1,969. *Id.* However, the OUCC went on to state that the $1,969 amount was based on the assumption that the entire plant was funded by contributions. Based on the OUCC's assumption that 80% of the expansion will be funded by an SDC, recalculation resulted in an SDC of $1,575. ([$1,142,000*80% / 580 EDU's]). Public's Ex. 1, p. 25. Therefore, the OUCC recommended an SDC of not more than $1,575 per 5/8" meter. The OUCC recommended a detailed accounting of the SDC, as well as segregation of the SDC funds to be used exclusively for capital projects which become necessary due to additional volumes of flow. The OUCC recommended that purchases for capital projects be listed and traceable to invoices, and that segregation be accomplished by a separate, interest bearing bank account designating it as a restricted use. *Id.*, p. 27.

Mr. Sommer testified that LMH has been charging $1,600 or $1,650 as an SDC. Transcript at A-10, lines 5 -14. Mr. Sommer stated that he had reviewed LMH's books back to 1987 and had seen "system development charges coming in" to LMH, although those funds were not shown on LMH's books as a system development charge. Tr. at A-11, lines 2-16. Mr. Sommer was unable to state with specificity how these charges could be identified in LMH's records. Indeed, the fees that are now classified as qualifying as system development charges have been listed as expenses in LMH's books. In Mr. Sommer's words, LMH

> never established an account they called a capital account for system development charges or contributions in aid of construction. [LMH] simply expensed it for tax purposes....[We're] going back and attempting to reconstruct how they spent it for individual capital projects....[T]hey paid for the capital improvements or the operating expenses out of these system development charges.

Tr. at A-13, lines 1-16.

As to the absence of the SDC on LMH's tariff, Mr. Sommer cited the Commission's determination in the *Boone County* case, which he characterized as the first time that utilities knew that all charges had to be tariffed, and the first time that the Commission 'decided' that it would regulate SDCs. Tr. at A-12, lines 3-14. *Boone County Utilities, LLC's Appeal of Decision Issued by Consumer Affairs Div.,* Cause No. 42093, 2002 Ind. PUC LEXIS 324 (Ind. Util. Regulatory Comm'n Apr. 17, 2002.)

LMH's reliance on *Boone County* for the position that it did not need to tariff its SDC is misplaced. *Boone County* did not create new law; it reiterated the requirement that utilities tariff all fees charged, and that such fees required prior Commission approval. In finding that Boone County's fee *did* need to appear on the tariff, the Commission stated that "inclusion of contribution fees in a utility's schedule of rates is consistent with previous Commission practice." *Boone County,* at *28. Boone County was ordered to file an amended tariff to include the contribution charge, which had already been approved in a prior proceeding. *Id.* at *29-31. The Commission also noted that "BCU should have provided a cost based analysis of its future capacity needs and the total number of EDUs that were going to be served by that future capacity, thereby arriving at a cost justified Contribution Fee." *Verified Petition of the Bd. of Comm'rs of Boone County, Ind. To Revoke the Certificate of Territorial Authority Issued to Boone County Utils., LLC,* Cause No. 42131, 2003 Ind. PUC LEXIS 344, *27-28, (Ind. Util. Regulatory Comm'n Dec. 17, 2003.)

As to the amount of the SDC, Mr. Sommer stated that the originally-requested amount of $3,000 was reached by consultation and review of other SDCs charged in the area surrounding LMH's territory. Mr. Sommer referred to an SDC approved by the Commission for Aldrich Environmental as support for the amount of the charge. However, each system development fee must be judged on its own merits; whatever sum was reached in another matter, with another unrelated utility, is of no moment to the case before us. Mr. Sommer stated that LMH will be "in a severe cash flow bind if it were denied this SDC. It is the intention of [LMH] to use these SDC funds only for capital additions such as this $450,000 funding gap." Petitioner's Ex. 6, p. 2, lines 12-15.

The requested SDC amount has now been reduced to $2,500 by virtue of the settlement. However, there is no evidence of record supporting the amount of the modified amount of the charge. While Mr. Sommer provided a late-filed exhibit that purported to explain the SDC calculation, that document provided only a calculation of what LMH would have collected from 1999 – 2005, had it been authorized to collect an SDC of $3,000. Petitioner's Ex. 7. No accounting evidence was offered to show how the $2,500 figure contained in the settlement was calculated.

The requirement that the fee be cost-based is not an unknown concept for LMH. We approved LMH's original tap-on charge with the explicit finding that the Commission had "evidence of actual expenses associated" with the cost of connection. *In the Matter of the Petition of*

L.M.H. Utils. Corp., Cause No. 39104, 1993 Ind. PUC LEXIS 8, at *6. We have disallowed connection charges previously when the amount was not cost-based. Indeed, the Court of Appeals has remanded charges to us with the instruction to recalculate connection charges "to be commensurate with appellee's cost related to the extension of its services[.]" *Twin City Realty Corp. v. Clay Utilities, Inc.,* 146 Ind. App. 629, 645, 257 N.E. 2d 686, 696 (Ind. App. 1970.) We therefore cannot find that this SDC amount is reasonable under the circumstances.

In addition, the settlement requests that we authorize the SDC retroactively and not make it subject to refund. *See*, Petitioner's Ex. 6, *Joint Stipulation and Settlement*, p. 2. This agreement again conflicts with the review of the books and records. If we approve the SDC retroactively, we would do so in the absence of evidence regarding the actual amount that LMH charged, the total collected, the number of customers that were charged, and the uses to which the funds were put. Mr. Sommer stated that LMH has charged such fees, perhaps by other names, since 1987 or 1988. Tr. at A-11, lines 4-10. We are unwilling to approve a settlement that impedes a full review of the fees charged by LMH; accepting a settlement that approves a fee unsupported by cost evidence, retroactive to some unknown date, is contrary to our regulatory obligations.

We therefore reject the parties' settlement regarding the SDC. We do not grant retroactive approval; we do not accept the settled amount of the SDC, which the parties agreed should be $2,500; and we do not accept that amounts previously collected are beyond refund. In the absence of a full examination of LMH's books and records, and those of its affiliates, the amount of, and need for, a system development charge, cannot be determined. We also find that the affiliate contracts provided as part of LMH's direct case do not contain sufficient documentation to satisfy the statutory requirements under I.C. §8-1-2-49. We therefore do not find that they are approved. We also find that LMH shall immediately cease to charge any system development charge, until further order of this Commission. Any fees currently held by LMH as a result of SDCs collected must be segregated in a separate interest-bearing account.

We therefore reject the settlement in its entirety. As noted at the outset, a utility is bound by the "fifteen month rule" of I.C. §8-1-2-42. Should LMH seek to re-petition the Commission consistent with those statutory strictures, it could do so by refiling a new rate case after the expiration of the fifteen months. As this case was filed on April 20, 2006, the fifteen month restriction would end on July 20, 2007.

As a consequence of our review of the evidence in this case and the nature of the issues raised, we expect that LMH will work cooperatively with the OUCC to address the concerns they raised in this proceeding. These concerns were, *inter alia*, LMH's failure to maintain books and records pursuant to NARUC's USoA; the OUCC's inability to create a balance sheet, capital structure, or rate base from LMH's existing books and records; inconsistencies between LMH's records and reports as to the amount of utility plant in service; LMH's skewed debt-to-equity ratio; LMH's failure to request pre-approval before providing service, implementing charges, or seeking financing; failure to seek approval from the Commission for plans and specifications to expand plant capacity; LMH's use of a depreciation method without Commission approval; LMH's failure to properly account for CIAC and cash advances for construction; LMH's use of insufficiently-documented affiliate contracts in absence of Commission oversight; the absence of cost-based evidence in support of a system development charge; and allowance of customer connections to LMH systems from sump pumps. This list is by no means exhaustive, and is illustrative of the issues cited by the OUCC in this case.

IT IS THEREFORE ORDERED BY THE INDIANA UTILITY REGULATORY COMMISSION that:

1. Consistent with the findings herein, we find that L.M.H. Utilities Corp. should take nothing by way of its petition in this matter.

2. The Stipulation and Settlement submitted by L.M.H. Utilities, Corp. and the OUCC in this Cause is rejected in its entirety.

3. This order shall be effective on and after the date of its approval.

GOLC, LANDIS, SERVER AND ZIEGNER CONCUR; HARDY ABSENT:
APPROVED: MAR 2 2 2007

I hereby certify that the above is a true and correct copy of the Order as approved.

Connie S. Childress

Connie S. Childress
Acting Secretary to the Commission